DOCUMENT RESUME

ED 141 226 SO 010 080

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TITLE An Analysis of U.S. Foreign Direct Investment Policy and Economic Development. A.I.D. Discussion Paper No. 36.
INSTITUTION Agency for International Development (Dept. of State), Washington, D.C.; Brookings Institution, Washington, D.C.
PUB DATE Nov 76
CONTRACT AID-CM-OTR-C-73-211
NOTE 123p.

EDRS PRICE MF-$0.83 HC-$6.01 Plus Postage.
DESCRIPTORS *Business Responsibility; Capital; Case Studies; Data Analysis; *Developing Nations; *Economic Development; Economics; Finance Reform; *Financial Policy; Financial Support; Foreign Countries; Government Role; *Investment; Needs Assessment; Policy Formation; Tables (Data); Taxes; Tax Rates

ABSTRACT

The purpose of the paper is to analyze U.S. policies toward financial investment in developing nations. The paper is presented in two sections. In section I, the controversial effects of direct foreign investment on development are discussed. Case studies of investment policies toward India, the Philippines, Ghana, Guatemala, and Argentina are presented. Review of theoretical and empirical knowledge concerning the impact of direct foreign investment on development indicates serious limitations in existing expertise. The effects of national income, jobs, and government revenues are generally positive. However, the impact on balance-of-payment positions and the exploitative nature of much investment are criticized. Section II presents an appraisal of post World War II investment policies. Topics discussed include taxation of foreign income, tax provisions applicable to developing countries, expropriation losses, alternative approaches, trade policies, risk insurance, and balance-of-payment controls. Review of these policies indicates that the effects of the American tax system in promoting direct foreign investment are highly questionable. The conclusion is that U.S. policy should respond differentially to particular cases and to interactions between policies of the host and home countries. (Author/DB)

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AN ANALYSIS OF U.S. FOREIGN DIRECT INVESTMENT POLICY AND ECONOMIC DEVELOPMENT*

A.I.D. Discussion Paper No. 36

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November 1976

*This report is the result of Contract No. AID/CM/OTR-C-73-211, undertaken by The Brookings Institution for the International Economic Analysis Division of the Office for Policy Development and Analysis. All views expressed are those of the author and do not necessarily reflect those of A.I.D., The Brookings Institution or the U.S. Government

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AN ANALYSIS OF U.S. FOREIGN DIRECT

INVESTMENT POLICY AND ECONOMIC DEVELOPMENT

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INTRODUCTION

The purpose of this paper is to analyze the impact on development of U.S. policies toward foreign direct investment, and to suggest changes in those policies which might improve the prospects for the poorer countries. Two analytical steps are necessary: an assessment of the impact of foreign direct investment on development, and an assessment of the impact of U.S. policy on foreign direct investment in the developing countries.

The effects of foreign direct investment on development are highly controversial. Supporters of multinational enterprises claim that they are perhaps the single greatest source of progress in the Third and Fourth Worlds.[1] Critics view them as retarding such progress. Hence a judgment about the effects of direct investment must precede an appraisal of the effects of U.S. policy toward such investment, to provide a basis for understanding the impact of the policy itself. A critical aspect of the question is the definition of "development" or "progress" in the poorer countries against which one should gauge the impact of foreign direct investment.

There is similarly great controversy over the impact of U.S. policy in this area. Some observers believe that U.S. policy toward foreign direct investment has ignored the developing countries, and even

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Throughout this paper, a distinction is made between Third and Fourth Worlds. The "Fourth World comprises the poorest of the developing countries, located almost wholly in South Asia and Sub-Saharan Africa, whose per capita income is approximately $200 or below, most of which are also referred to as being least developed. Almost all of these LDCs appear on the list of countries "most seriously affected"(MSAs) by the energy crisis and world recession. The "Third World"comprises all other developing countries, including almost all of Latin America, East Asia and the Middle East.

discouraged such flows to them. Others believe that the United States has actively supported, and even subsidized, an expansion of foreign direct investment in the developing world. This latter school of thought, in turn, subdivides into some who believe that the U.S. motive for doing so has been imperialistic and exploitative, and some who believe that the United States has genuinely sought to promote development via the route of private enterprise as well as official aid and other means.

This paper thus brings together several issues, each of which is highly controversial: the meaning of "development," the role of foreign direct investment and multinational enterprises, and U.S. policy toward both. Our effort here is to assess the theoretical and empirical evidence which bears on each issue, and on the interactions among them, to provide a foundation for the consideration of alternative U.S. policies toward foreign direct investment which could improve its contribution to development -- and to suggest further avenues for research which could help provide better answers to all these questions in the future. The paper draws on the analyses and conclusions in American Multinationals and American Interests, a book prepared for the Brookings Institution by C. Fred Bergsten, Thomas Horst and Theodore H. Moran, in which portions of this paper will appear.[2]

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[2] American Multinationals and American Interests provides a comprehensive analysis of the impact of foreign direct investment by firms based in the United States on the economy and foreign policy of the United States, including the effects of such investment on the functioning of the international economic system. It is scheduled for publication in early 1977.

FOREIGN DIRECT INVESTMENT AND DEVELOPMENT

Economic Theory

Neoclassical economic theory and standard development theory combine to suggest unequivocally that foreign direct investment will have a positive impact on the poorer countries. Development is constrained by shortages of foreign exchange in the standard two-gap models.[3] Foreign direct investment brings in external capital. Hence foreign direct investment promotes development.

In addition, foreign direct investment pursues the highest rate of available return. So it must increase world welfare. The market allocates the benefits of the foreign investment, some of which are bound to accrue to the host country.[4]

History provides some support for this model. Foreign capital played an important role in the development of many of the presently industrialized countries, including the United States. It was also important in the postwar reconstruction of Europe.

However, virtually all of the external capital involved in those earlier development cases came in the form of private portfolio lending or governmental aid. Foreign direct investment was a small component of the picture.[5] When foreign direct investment did occur, it went almost

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3 H. Chenery and A. Strout, "Foreign Assistance and Economic Development," American Economic Review, Vol. LVI, Sept. 1966.

4 G. D. A. MacDougall, "The Benefits and Costs of Private Investment From Abroad: A Theoretical Approach," Economic Record, March 1960.

5 U.S. direct investment capital flows to Western Europe exceeded $100 million in only two years prior to 1956, when the reconstruction process had been virtually completed, and averaged less than $55 million annually from 1946 through 1955. U.S. Government assistance, by contrast, averaged over $2.5 billion annually for the same period.

wholly into extractive industries rather than manufacturing -- the focus of the issue today.[6] Japan achieved the most spectacular of all the postwar development successes while deliberately banning most inward direct investment. China, whose development model is appealing to some, has avoided such investment altogether. So the historical record is inconclusive.

The applicability of historical references is further clouded by the fact that the development of the currently industrialized countries was defined almost wholly in terms of an expanding gross national product. By contrast, the targets of development have become much more numerous and disaggregated during the last decade. One of the chief contemporary concerns is income distribution, which found little if any place in the policy focus of earlier periods. Even employment, now a primary issue in virtually every developing country, was only a derivative target prior to the 1930s.

Many of the issues raised by direct investment were in fact not addressed by classical economic theory. These include the oligopoly nature of the vast majority of the investors, their packaging of several key factors of production, their use of large chunks of local capital to augment their own, and the political and economic implications of the external control which accompanies direct but not portfolio investment. Even when neoclassical analysis sought to cope with some of these problems by looking specifically at the more disaggregated effects of foreign

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6 Less than one-half of annual U.S. foreign direct investment flows to Europe were for manufacturing investments prior to 1960.

direct investment -- on jobs, tax revenues of host countries, trade balances, technological advance and a variety of externalities[7] -- it continued to view foreign direct investment as a phenomenon in search of the highest possible return, and retained the traditional assumptions and reliance on market forces to distribute the gains.[8] Hence it likewise concluded, with a bit more elaboration and disaggregation, that the process could only have positive developmental effects.

In the middle 1960s, more sophisticated analyses of both foreign direct investment and of the development process began to raise doubts about these results. Industrial organization economists demonstrated that foreign direct investment was dominated by oligopolistic industries. Hence investment did not necessarily take place where returns, as conventionally defined, were highest -- and there was no assurance that world resources would be best allocated by such activity. From a distributional standpoint, this insight negated the classical view that competitive market forces allocated the benefits generated by foreign direct investment. By definition, oligopolistic industries dominate the markets for their products and indeed seek to maximize on a

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7 The most comprehensive recent effort is Grant Reuber, Private Foreign Investment in Development (Oxford: Clarendon Press, 1973).

8 For example, MacDougall, op.cit., encompassed all of the standard assumptions of neoclassical theory: full employment, constant balance-of-payments equilibrium, no taxation, no relationship between the stocks of host-country and foreign capital, no external economies, constant returns to scale, perfect competition, and constant terms of trade. Such models are of course static, and make no comparison with "what would have happened otherwise." When he relaxed some of the assumptions of the competitive model, MacDougall interestingly concluded that higher tax revenues are likely to be the channel through which most of the benefits of foreign direct investment accrue to the host country.

global basis the rents available to them from that domination. Bargaining over rents thus became a central consideration in assessing all of the effects of such investment, including its effects on developing (and other) countries.

The proponents of this new approach were divided from the outset as to its implications for development. One school viewed it as probably negative,[9] while another thought it still positive.[10] There also developed, in the wake of the oligopoly models, a school of thought which regarded foreign direct investment as a total retardant to development: the "dependencia" theorists, who saw only adverse effects on the whole range of economic and social conditions of concern to poorer countries.[11] All three viewpoints began to focus directly on the very issues which were becoming widely viewed as critical to development: jobs, income distribution, and export potential.

This new developmental focus emerged from growing concern, and empirical evidence, that GNP growth was insufficient to achieve the goals of development. Unemployment was rising in the poorer countries,

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9 For the pessimistic view see the numerous works of S. Hymer, especially "The Multinational Corporation and Uneven Development," in J. Bhagwati (ed.), Economics and World Order (New York: MacMillan, 1972).

10 For an articulation of the optimistic position see several writings by R. Vernon, especially "Foreign Owned Enterprises in the Developing Countries," Public Policy 15 (1966), pp. 361-380 and "The Process of Economic Development," Chapter 9 in The Economic Environment of International Business (Englewood Cliffs, N.J.: Prentice Hall, 1972).

11 See O. Sunkel, "Big Business and 'Dependencia': A Latin American View," Foreign Affairs, Vol. 50, No. 3 (April 1972), pp. 517-531, or T. Dos Santos, "The Structure of Dependence," American Economic Review, Vol. LX, No. 2 (1970).

including some which were achieving reasonable overall growth.[12] Increases in national income were in some countries accruing largely to upper income groups, with increases in income maldistribution (see Table 7). Growing debt burdens meant that improvements in the trade balance, rather than capital inflows, were increasingly needed to reduce the foreign exchange gap.

Hence the newly perceived capabilities of the multinational enterprises and the newly recognized imperatives of development meshed -- some would say clashed -- across a number of issue-areas. The effects of foreign direct investment on the growth of GNP in the poorer countries remain of great importance. But any assessment of its impact on the development process must necessarily encompass these more disaggregated considerations as well.

Such an assessment must compare the actual effects of foreign direct investment with the effects of the alternative use of the same host-

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12 Due primarily to the rapid growth of population. David Moravetz, "Employment Implications of Industrialization in Developing Countries: A Survey," Economic Journal (September 1974), points out that "a manufacturing sector employing 20 percent of the labor force would need to increase employment by 15 percent per year merely to absorb the increment in a total work force growing at an annual rate of 3 percent." For data on the steady increase in unemployment in many rapidly growing countries during the 1960s see United Nations, World Economic Survey, 1969-1970, p. 128.

country resources which are used in conjunction with the investment. If the resources would otherwise be unemployed, then the investment is almost certain to be beneficial.[13] However, alternatives are now frequently available to developing countries.[14] Local firms may be able to carry out the same tasks as multinationals. At some cost to the balance of payments, the goods produced locally by a multinational enterprise can be imported instead.

Even more importantly, the external inputs heretofore available only as packaged by foreign direct investors can now frequently be obtained separately. Foreign portfolio capital is again available to developing countries, and they have in fact borrowed tens of billions of dollars in recent years. Foreign technology can often be licensed, as Japan has demonstrated throughout its postwar development. Management and marketing can be bought through service contracts, as is occurring throughout even the extractive industries where they were once tied inextricably to foreign equity ownership. All of these economic factors are not of course available from a variety of sources for all projects in all developing countries, but the range of available alternatives

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13 It is theoretically possible for foreign direct investment to be harmful in such circumstances, because the same resources could have been exploited for greater local benefit in the future or because their exploitation actually damages the country, but such cases are unlikely to occur in practice. This point was established by Harry Johnson, "The Possibility of Income Losses from Increased Efficiency or Factor Accumulation in the Presence of Tariffs," Economic Journal, Vol. LXXVII, No. 305 (March 1967), pp. 151-154.

14 For an excellent exposition of feasible alternatives see Paul Streeten, "Costs and Benefits of Multinational Enterprises in Less Developed Countries," in John Dunning (ed.), The Multinational Enterprise (New York: Praeger, 1971), pp. 240-258.

has risen dramatically in the past few years. And the components of foreign direct investment can be teamed with local resources in joint ventures and a number of other forms which can alter the impact on the developing country.

Furthermore, developing countries now can choose among multinational enterprises based in many countries. Until the last few years, U.S.-based firms dominated the direct investment process. They still account for almost 50 percent of such investment. But the overseas involvement of firms in the other industrialized countries, particularly Japan and Germany, have been growing much faster: by 28.3 percent and 22.8 percent, respectively, from 1960 through 1971. Multinational enterprises based in countries other than the United States, to compensate for their position as latecomers, in fact frequently accept entry conditions refused by American-based firms. Developing countries which want foreign direct investment now have a far wider choice of multinationals, and comparisons among the different firms is another element in assessing the effect of a particular investment on development.

Indeed, as a result of these and other structural changes in world economic and political relationships, a central element in the evolving impact of foreign direct investment on development is the growing ability of host countries, including those in the Third and even Fourth Worlds, to harness the multinational enterprises to promote their national objectives.[15] One important finding of this paper is that it is extremely difficult to generalize about the development impact of foreign direct

15 For details on the pervasiveness of this phenomenon see American Multinationals and American Interests, especially Chapter 10.

investment, and that host-country policies -- both toward the investment itself and in using the resources which it generates -- will often be decisive. Such a finding is no counsel of despair. Indeed, it suggests that proper host-country strategies -- particularly if supported by better policies in the United States (and other home countries of multinational enterprises) -- can significantly improve the contribution made by foreign direct investment to that process.

Because of these structural changes, the task of analyzing the impact of foreign direct investment on a particular developing country has become both more difficult and more meaningful. It is difficult to ferret out the realistic alternatives in a particular case, from among the growing array of possibilities, and macroeconomic models are of little use in the process. And the data have not yet caught up with the swing toward greater host-country control, so empirical evidence of its effects remain incomplete.[15a] But meaningful results can now be obtained from a comparison between the benefits and costs of alternatives which, in the real world, are increasingly available.

Future analyses of the impact of foreign direct investment on development need to focus in two directions: quantification of the extent to which alternatives are available in specific sectors, and quantification of the differences (on the array of development criteria) between foreign direct investment and those alternatives. In this paper, we will draw on the few studies of this type which

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15a One notable exception is Kenneth S. Mericle, "The Brazilian Motor Vehicle Industry: Its Role in Brazilian Development and Its Impact on United States Employment," A Report for the U.S. Department of Labor, July 1975, which documents the shift of production and jobs from the United States (and other home countries) to Brazil occasioned by the Brazilian requirements levied on incoming multinational firms.

have already been undertaken. Much more such analysis, however, is essential if U.S. policy -- and the policy of host countries, and the interaction between them -- is to become more effective in promoting the developmental contributions of foreign direct investment.

Empirical Results: Aggregate Effects

The major controversies surrounding the impact of foreign direct investment on development relate to such investment in the manufacturing industries. The issue concerning investment in raw materials is the division of rents between the companies and host countries, and most of its implications are well understood (if still, at times, a source of major problems).[16] In addition, U.S. developmental policy as regards foreign direct investment is almost wholly addressed to manufacturing. Hence this discussion will focus primarily on that sector.[17]

In terms of broad economic aggregates, foreign direct investment by U.S.-based multinational enterprises are an important if not overwhelming factor in Latin America.[18] In 1966, their sales in all

16 See Chapter 5 of American Multinationals and American Interests.

17 This leaves out the services sector, a rapidly growing area for foreign direct investment (banking, tourism, shipping, etc.). Despite its importance, there are even fewer data on it than on the other sectors.

18 82.1 percent of all U.S. foreign direct investment in manufacturing industries was in that region at the end of 1974. Virtually all the rest was in the Far East. Survey of Current Business, October 1975, p. 53.

(including the extractive) industries equalled 13.7 percent of its Gross Domestic Product (GDP).[19] Sales by majority-owned foreign affiliates of U.S. firms (MOFAs) accounted for 6.3 percent of Latin American GDP in the manufacturing sector. The ratios may have grown since that time. No reliable aggregate data are available, but recent studies show that foreign direct investment by all (including European and Japanese) multinationals make up fully 50 percent of the manufacturing sectors in Brazil and Mexico, a large share of which is accounted for by MOFAs.[20]

These data set the magnitude of foreign direct investment, but say nothing about its impact on development even at the aggregate level.[21] There have been two major efforts to estimate those effects. We review each in turn.

The study jointly authored by Bos, Sanders and Secchi was commissioned by the OECD.[22] It seeks to establish the effects of foreign direct investment in five countries (India, Philippines, Ghana, Guatemala and Argentina) on their total national income, for both marginal additions of

19 Herbert K. May, The Effects of U.S. and Other Foreign Investment in Latin America (New York: Council for Latin America, 1970).

20 R. Newfarmer and Willard F. Mueller, Multinational Corporations in Brazil and Mexico: Structural Sources of Economic and Noneconomic Power (Washington: GPO, 1975).

21 May erroneously presented his data as a measure of the net benefits of foreign direct investment, using sales as a proxy for income created by foreign direct investment and then comparing it with domestic value-added. He justified this approach by appealing to unspecified indirect effects, but made no empirical estimates of them. Furthermore, his results were based on preliminary data which have since been substantially revised.

22 H. C. Bos, Martin Sanders and Carlo Secchi, Private Foreign Investment in Developing Countries (Boston: D. Reidel, 1974).

foreign direct investment and for its cumulative effects over the entire period of observation; on the balance of payments, taking into account both trade and financial flows; on public savings, including tax revenues not only from capital but also from resulting labor income; and on private savings, which will not be reported here because they were derived simply by multiplying the net income generated by foreign direct investment by the country's marginal propensity to save.

The model used by Bos markedly increases the level of sophistication of macroeconomic studies in this area, due to its inclusion of many indirect effects and its attempt to explore interactions between the foreign and domestic sectors. Within the model, however, there are several theoretical problems which, when coupled with the extreme data problems inherent in all such studies, necessarily require caution in accepting its empirical results.[23] In addition, Bos did not seek to compare the results of foreign direct investment with the likely results of alternatives available to the host country.

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23 The major theoretical problem with the model is its interaction between the balance of payments and income effects. Capital outflows in the foreign direct investment sector are treated as increasing national income, on (a) the grounds that ex ante balance-of-payments deficits make resources available for development and (b) the assumption that the deficits will be met in ways which do not check growth. This scenario is unlikely in developing countries, and severely hampers the application of the model. In the case study of the Philippines, for example, the fact that several sectors generated positive balance-of-payments effects results in an overall shrinkage of the income effect. Other important theoretical shortcomings include the complete absence of price data and the assumption of constant capacity utilization in both the foreign and domestic sectors, which is wholly unrealistic and distorts the empirical estimates. The lack of adequate empirical data also forces the authors to make numerous assumptions concerning key parameters.

Despite these shortcomings, the results are of use because they represent one of the first systematic attempts to explore the relationships between foreign investors and the rest of the economy.

For India, Bos found that the cumulative income effect of foreign direct investment is positive, though rather small with regard to the overall income of the country due to the small share of the foreign sector in the Indian capital stock. Within the sample period, several calculations of marginal income were negative due to an assumption that all foreign direct investment income was repatriated,[24] with the result that all expansion of the wholly owned subsidiaries was carried out with domestic savings and local investment was squeezed. Joint ventures performed better, under the assumption that all dividend income accruing to the local partners was subsequently reinvested.

For the balance of payments, the marginal effects were negative for all years and the cumulative effect sizably negative. This is largely a result of the assumption concerning repatriation of earnings. However, sizable import requirements coupled with poor export performance by the subsidiaries resulted in negative trade flows as well.

The effect of foreign direct investment on public savings was positive and sizable. This was due mainly to the positive income effect,

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24 In 1974, manufacturing MOFAs actually repatriated only $8 million of their $25 million of adjusted earnings in India. In 1973, however, they repatriated $13 million and reinvested only $4 million. Survey of Current Business, October 1975, pp. 57-61.

but also to a fairly effective structure of profits taxation which more than offset expenditures required to support the investors. Indeed, public saving resulting from foreign direct investment was almost 20 percent of the income effect, the highest in the sample.

For the Philippines, the cumulative income effect was positive and the marginal calculations were never negative. The effects on the balance of payments were significantly less negative than for India, as a result of lower rates of repatriation and low import requirements for the foreign direct investment sector. Indeed, several sectors improved the overall balance of payments (though, as a result of the peculiar structure of the model, their income effect was thus reduced). The public savings effect was positive and amounted to almost 13 percent of the income effect.

For Ghana, the results are once again favorable. The income effects are greater than in India, though there are some negatives for several sectors for one year.[25] The balance of payments effects for Ghana were large and in all cases negative due to sizable repatriation, significant import requirements and poor export performance. The public saving effect was positive, comparable to that in the Philippines.

Guatemala experienced the least positive effects of the countries studied. The income effect is favorable, but significantly less than in the other cases due to the squeezing of domestic investment by a rapidly growing foreign sector. The balance of payments effects are

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25 Due to foreign disinvestment in those years.

strongly negative and larger than for the other countries due to sizable repatriation of income, significant import requirements and relatively poor export performance. A striking result is the almost complete absence of public savings generated by foreign direct investment -- only about 5 percent of income generated by foreign direct investment -- largely due to Guatemala's low income tax rates. In several sectors (notably textiles, chemicals and fabricated metals) the structure of taxation coupled with expenditures carried out to support the investors resulted in negative public savings.

In Argentina, where foreign direct investment was most important to the overall economy, the income effect was again positive. The balance of payments effect was negative, but significantly less so than in India, Ghana and Guatemala. Once again, the public savings effect was small -- about 6 percent of income generated -- primarily due to the tax structure.[26]

Bos et al caution that their countries studied should not be viewed as a representative sample of developing countries. Nor should the results be generalized, even with their shortcomings carefully appended, because of the sharp differences among different countries. Nevertheless, several patterns emerge from the results. The effects of foreign direct investment on national income are always positive, although they may be

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26 For both Guatemala and Argentina, however, Bos calculated local tax rates simply by comparing the rate of direct tax collections to GNP. (He then applied this ratio to the portion of GNP attributable to foreign direct investment.) For India, he had much more detailed information concerning tax rates.

negative in some years for some sectors. The effects on government revenues are thus also positive, though by amounts varying from 2 to 20 percent of the impact on total income in light of host-country tax policies. By contrast, the effects on the balance of payments are always negative, albeit by quite different magnitudes for the different countries. In addition, the net income effect of foreign direct investment was in each case less than the value-added created directly by such investment, implying that its indirect effects on GNP were always negative.[27]

But many of the results flow inherently from the structure of the Bos model. Its simplistically historical view of the capital flows associated with foreign direct investment -- inflows and repatriation in each year are simply netted against each other -- virtually assures a negative balance of payments result. The inverse relationship posited between income and the balance of payments in turn virtually assure a positive reading on GNP and, through it, on government revenues. The most useful findings of the study are thus twofold: its gradations of effects among the different countries, suggesting that host-country policies can be of great significance in improving their gains from foreign direct investment; and its important tentative results on the relationship between the direct and indirect effects of foreign direct investment.

The fundamental problem with the Bos analysis, like that of most

27 This raises particularly acute doubts about the validity of the conclusions reached by simple macroeconomic studies which do not take account of such feedback from foreign direct investment into the domestic economy.

studies of the subject, is that it essentially compares the economy of the host country with foreign direct investment against a situation in which the economy has no foreign direct investment and no alternative sources of the needed inputs. While this method and its underlying assumptions may have had some degree of applicability in the past, the reasons for adopting another standard are now overwhelming.

The relevant measure of the effect on the host country is the difference between the net benefits derived from foreign direct investment and the net benefits of the alternatives. However, the task of providing the alternatives with empirical content is difficult. The analyst not only faces massive data problems, which plague all investigations of foreign direct investment, but must make some rather simplistic assumptions concerning the behavior of key macroeconomic variables in the host country. Nevertheless, Streeten has attempted to use Little-Mirlees (L-M) project analysis techniques to compare the performance of 159 companies in six countries with two alternative possibilities: (a) importing the products, and (b) obtaining the foreign capital in portfolio form but with the technology and hence the input requirements of the local firm remaining the same as that of the foreign firm ("financial replacement").[28]

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28 P. Streeten and S. Low, The Flow of Financial Reserves: Private Foreign Investment: Main Findings of a Study of Private Foreign Investment in Selected Developing Countries, UN TD/B/C.3/111, May 1973. The terminology of project analysis differs from that which we have been using. In the previous section, the income effect was some measure of contribution to GNP. After suitable refinements, the "net income effect" was a measure of the value added produced in the host country and retained in the host country. In the L-M method of project analysis, the "net income effect" is equal to the "net change in income brought about by a firm, derived by subtracting from the value of its production the entire value of output

There are a number of limitations to this work too. First, it assumes that foreign direct investment has no effect on critical macro-economic variables such as prices and income. Second, none of the benefits or costs of foreign direct investment commonly classified under the rubric of "externalities" are captured. A third difficulty is the valuation of the domestic inputs employed in the project, especially "nontradable" inputs. The Streeten studies are extremely valuable, however, in their comparison of the results for 159 firms (109 majority owned, 38 minority owned, 12 domestically owned) in six countries (Iran, India, Colombia, Kenya, Jamaica and Malaysia) with the possible alternatives evaluated quantitatively over 5-7 years in the late 1960s.

In terms of balance of payments effects, the overwhelming number of firms exported more foreign exchange than they earned. This was true for all countries and most firms: 8 of 11 for Jamaica, 3 of 8 for Kenya, 48 of 53 for India, 14 of 15 in Malaysia, all 16 in Iran and all 56 in Colombia. On this important variable, the quite different Streeten and Bos approaches yield similar results.

There are several reasons for these results. The export performance

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which would have been produced in the alternative situation where the firm was absent." See P. Streeten and S. Lall, Balance of Payments Effect of Private Foreign Investment in Manufacturing: Case Studies of India and Iran, TD/B/C/3/V/Misc. 1, Dec. 1971, p. 11. This effect is calculated simply by evaluating the output at world prices and subtracting the value of all scarce inputs, also valued at world prices. Hence it measures the efficiency of resource allocation rather than income generation, and implicitly assumes that the same production would be carried out by someone else in the absence of the foreign investor. The balance of payments effect is simply the change in income which is saved per two-gap analysis, where ex post savings equal the foreign exchange gap.

of the overall sample was unimpressive. The median firm exported only 15 to 19 percent of its total sales. Exports were negligible for 53 percent of the firms. In part, this suggests that the sample may be biased toward import-substitution or domestic-market investments. It also indicates, however, that the oft-cited ability of the multinational enterprise to export may not be a general phenomenon.[29] Indeed, in this sample, exports in the case of India seem to be largely a function of government coercion.

For capital flows alone, only 58 of the firms generated an inflow to the host country. There was sizable variation across countries: Kenya had the greatest proportion of firms with positive capital flows, while Colombia had the lowest. There appears to be no basis on which to classify the results, though age of subsidiary did appear to be correlated with net outflows in the case of Kenya.[30]

A third component of the balance-of-payments effect on the host country is import savings, which are a function of the extent to which the value-added of the final product is produced within the host country. The study shows that 40 percent of the firms imported over 30 percent of the value of their sales, and nearly 60 percent of the firms imported over 20 percent. Again, there is sizable variation across the countries and within countries.[31]

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29 These doubts are reinforced by our analysis of the issue below, pp. 48-51.

30 As would be expected theoretically: the older the affiliate, the greater its earnings on the previously accumulated stock of investment relative to increments in that investment.

31 While Streeten does not attempt to discern a pattern in the results, Reuber, op.cit, p. 153, demonstrates that "export-oriented" subsidiaries import a substantial portion of their value added from the parent: 59.2 percent in 1970, 50.8 percent in 1972. His "market-development" subsidiaries have greater local linkages, but still purchased 28.2 percent of their inputs from the parent in 1972.

Streeten's analyses of the net effects of foreign direct investment on national income -- which is essentially an efficiency effect, resting on the implicit assumption that someone else would undertake the production in the absence of the foreign investor -- produce several interesting results.

There is a wide difference among the different countries. For Kenya, the average income effect was 12.7 percent of sales with foreign majority firms outperforming the single foreign minority firm. In Jamaica, for which the sample consisted only of majority-owned subsidiaries, the effect was 7 percent of sales. The Indian sample indicated an even smaller effect on income: the average for the entire sample was 1.3 percent of sales, with foreign majority-owned plants much superior to either joint ventures or domestically owned firms, both of which yielded negative income effects. The overall income effect for Iran was 5.6 percent, with majority-owned firms once again significantly outperforming minority or totally domestic ventures. For both Colombia and Malaysia, however, the effects were negative, averaging -1.5 percent and -4.5 percent, respectively. In both countries, joint ventures significantly outperformed majority-owned projects.

In addition to the sizable variations between countries, a firm-by-firm breakdown within the countries showed remarkable range. For the total sample, 11.3 percent of the firms had positive income effects amounting to 20 percent or more of the value of sales. There was also a wide range within particular countries. For example,

the Colombian sample had 17 firms generating positive income effects of over 10 percent of sales, but also 12 firms yielding negative effects of greater than 10 percent of sales (Table 1).

The results of the study could not be classified in any meaningful way. Regressions did not yield significant relationship between performance and variables such as age of the subsidiary, ownership structure, industry nor place of location. The only significant variable was the measure of effective protection.

The Bos and Streeten approaches show some marked differences in their appraisal of the impact of foreign direct investment on host-country income. Bos found positive effects for all countries, while Streeten found a negative impact in two of his six countries. Their aggregate conclusions were similar for India, the only country common to the two studies, but Bos found that joint ventures performed better than foreign majority-owned plants while Streeten reached an opposite conclusion.[32] The comparability of the two studies is severely limited, however, by their different methodologies, countries, and company coverage.

When Streeten compares the results of foreign direct investment with the alternative of borrowing the same capital from arm's-length foreign sources, he finds that the social costs of replacing the foreign capital would be less than the social costs of servicing it

32 This difference is at least partly explained, however, by Bos' assumption that all profits accruing to Indian partners in joint ventures were reinvested whereas all profits accruing to the foreign investors were repatriated.

Table 1

INCOME EFFECT OF FOREIGN DIRECT INVESTMENT BY COUNTRY AND FIRM

(number of firms in each category)

	Positive				Negative			
	More than 20%	10.1 to 20.0%	5.1 to 10%	0.1 to 5%	0 to -5%	-5.1 to 10%	-10.1 to 20%	Less than -20%
Kenya	2	2	2	-	1	-	-	1
Jamaica	2	1	2	2	1	-	3	-
India	5	7	10	7	5	4	9	6
Iran	6	4	-	1	1	1	1	2
Colombia	3	14	8	11	7	1	4	8
Malaysia	-	4	4	-	1	1	1	4
Total	18	32	26	21	16	7	18	21
% of Total	11.3	20.1	16.4	13.2	10.1	4.4	11.3	13.2
Total Positive	97 (61%)				Total Negative	62 (39%)		

Source: P. Streeten and S. Low, The Flow of Financial Resources: Private Foreign Investment, TD/B/C.3/111, May 1973, p. 20.

in 40 percent of the cases. In general, if the cost of capital is less than 10 percent, it would be more efficient for the host country to borrow than to accept direct investment and its resulting servicing costs (though one must remember that Streeten ignores all externalities and hence assumes that the complementary management, technology, etc. could be found to carry out the projects). Another interesting aspect of the "financial replacement" comparison concerns the planners' time preference: if the planner places a greater weight on future cost than present cost, debt capital which is eventually paid off entirely is even more desirable than foreign equity capital, payments on which must be made until divestment (if ever).

The Streeten analysis appears to indicate that, within the developing countries, a sizable number of subsidiaries are yielding negative as well as positive net social income effects. As in the Bos study, however, there is little pattern in the results. One inference, again, is that host-country policies can have a marked effect on the outcome. Streeten concluded that all projects must therefore be evaluated individually and that developing countries must seek to negotiate the best deal possible for themselves on each.

Empirical Results: Jobs

As indicated earlier, development programs in most countries no longer rely solely on increasing GNP to meet the priority targets of jobs and better income distribution. In addition, emphasis in many

countries has shifted to export expansion, from import-substitution and foreign borrowing, in coping with the balance-of-payments constraint to development. The contribution of foreign direct investment is thus increasingly gauged in terms of its impact on these three variables.[33]

It is clear that multinational enterprises offer employment by virtue of their very existence in host countries. Some analysts believe that the issue needs no further discussion, since rates of unemployment are high in virtually all poor societies. However, labor -- both skilled and unskilled labor -- is not always highly fungible in developing countries. Additional foreign direct investment may simply bid up the wages of skilled workers whose supply schedule is highly inelastic; additional investment (foreign or domestic) in southern Brazil may do little to reduce unemployment in the Nordeste.

At the same time, charges are frequently leveled that multinationals bring "inappropriate" technology to host countries, particularly capital-intensive techniques suited to their home countries (and to industrialized host countries) but not to situations where the relationship between factor costs is very different. On this reasoning, multinational enterprises could provide more jobs than they now do. In some cases, preemption of local firms by multinational enterprises could thus reduce the level of local employment.

There is even less empirical evidence on this issue than on most of those discussed heretofore. In aggregate terms, U.S.-based manufacturing

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33 Food production is another primary objective of development in most countries, but is too specialized for consideration here.

MOFAs apparently employed about 525,000 workers in 1966, including about 413,000 in Latin America.[34] The corresponding numbers for 1975 would appear to be about 1.5 million jobs in all developing countries and perhaps 1 million in Latin America (see Table 2). Over 99 percent of these workers were local. The jobs created in 1966 generated a total wage bill of $1.4 billion, including $1.2 billion in Latin America. (Table 3. The numbers are updated in Table 4 to $3.2 billion and $2.5 billion, respectively, in 1973 by simple application of the coefficients from the 1966 benchmark survey to the global sales figure for MOFAs in 1973.)

Although the income statements in Tables 2 and 3 provide data on MOFA expenditures for materials and services, it is impossible to ascertain the extent to which these expenditures were local. Such local expenditures are a measure of the spread effects of foreign direct investment, and could provide a basis for estimating its indirect impact on jobs. Available case study data indicate that approximately 45 percent of the inputs are purchased from the parent or another subsidiary, 45 percent are purchased locally and the remaining 10 percent are from other sources. Import-substitution projects appear to be much more integrated into the local economy than export-oriented projects,

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34 Department of Commerce, U.S. Direct Investment Abroad 1966, final data. Reuber, op.cit., p. 169, by classifying the subsidiaries by the industry of the parent, concluded that MOFA employment in manufacturing was 718,000 workers in 1966. But many MOFAs have subsidiaries in LDCs that are engaged in either marketing or raw material production, with much smaller job creation than the manufacturing sector in which their parents are categorized.

Table 2

EMPLOYMENT CREATED BY U.S. MOFAs:

1966, 1970, 1973, 1975

	All Developing Countries				Latin America
	Alternative 1	Alternative 2	Alternative 3	Alternative 4	Alternative 1
1966	525,000	525,000	547,267	na	413,000
1970	723,017	864,800	758,800	758,800	568,775
1973	871,607	1,503,000	1,318,800	1,178,769	685,604
1975	970,667	na	na	na	763,490

na - not available

Alternative 1: An average absolute increase per year was calculated for 1966-1970, by applying the growth rate of the sample data (8.3%) to the universe data, and projecting to 1973 and 1975. The 1966 figure comes from Table K-1, p. 190, U.S. Direct Investment Abroad 1966, final data.

Alternative 2: Sales/employee ratios from the 1966 benchmark survey applied to sales data (which are universe estimates) for 1970, 1973.

Alternative 3: Average sales/employee ratio for Brazil and Mexico for 1966 and 1970 applied to total sales for 1966 and 1970. Ratio for 1970 applied to sales for 1973.

Alternative 4: Average sales/employee ratio for 1966 and 1970 projected to 1973 and applied to 1973 sales.

Table 3

INCOME STATEMENT OF U.S. MOFAs: 1966

	All Developing Countries	Latin America
Income	8,730	7,462
Sales	8,585	7,337
Dividends	145	125
Cost and expenses	8,242	7,055
Goods and services	5,239	4,459
Employee compensation	1,389	1,232
Depreciation	309	250
Interest	205	174
Foreign income tax	314	263
Taxes other than income	240	204
Other costs	546	474
Net income after tax	489	407

Source: U.S. Direct Investment Abroad 1966, final data, Tables J1-J16.

Table 4

ESTIMATED INCOME STATEMENT OF U.S. MOFAs: 1973

	All Developing Countries	Latin America
Income	20,171	15,230
Sales	19,722	na
Dividends	449	na
Cost and expense	19,045	14,708
Goods and services	12,105	9,348
Employee compensation	3,208	2,478
Depreciation	713	551
Interest	473	366
Foreign income tax	726	560
Taxes other than income	554	428
Other costs	1,262	975
Net income after tax	1,130	873

This table was estimated by applying the ratios of the various variables to sales in 1966 to total sales in 1973.

which tend to receive well over 50 percent of their inputs from the parent.[35]

As already noted, an issue closely related to the employment contribution of foreign direct investment is the extent to which "appropriate" production processes are undertaken by the multinational enterprises. The limited data with regard to adaptation to LDC conditions indicate little positive action to date, either with regard to products produced or the production process.[36]

The reasons for this "lack of adaptation" remain to be established. Some have argued that, as a result of the incentive structure in most LDCs, factor prices do not reflect underlying factor endowments. An examination of existing incentive programs does indicate that most of the subsidies seem to favor the use of capital.[37] Furthermore, local firms seem to use the same techniques as multinational enterprises. Indeed, local firms are sometimes even more capital intensive. This is sometimes viewed as due to the "demonstration effect" of foreign firms; however, it may well be the structure of these incentives which accounts

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35 Reuber, op. cit., p. 161.

36 J. Baranson, "Multinational Corporations and Developing Country Goals for Technological Self-Sufficiency," mimeo, 1972; H. Hughes and You Pola Seng, Foreign Investment and Industrialization in Singapore (Madison: University of Wisconsin Press, 1969); L. Reynolds and P. Gregory, Wages, Productivity and Industrialization in Puerto Rico (Homewood, Ill.: R. D. Irwin, 1965); and Constantine Vaitsos, "Employment Effects of Foreign Direct Investments in Developing Countries," in Edgar O. Edwards, ed., Employment in Developing Nations (New York: Columbia University Press, 1974). For a somewhat more optimistic view, see William H. Courtney and Danny M. Leipziger, "Multinational Corporations in LDCs: The Choice of Technology," Oxford Bulletin of Economics and Statistics, Vol. 57, No. 4 (November 1975), pp. 297-304.

37 Such as accelerated depreciation and duty free imports of capital equipment.

for the choices of both the multinational enterprises and the domestic firms.

Others argue that the lack of adaptation is a conscious decision of the firms. Product adaptation is not given serious consideration since it may affect product differentiation, the firm's market share and hence its rents. Techniques of production are not altered due to a desire to minimize labor trouble or simple inertia on the part of management. Research has established the significance of the lack of adaptation to underlying factor environments, but not the causes of the phenomenon.

Several studies have indicated that the corporate preference for sticking with the capital-intensive techniques of the home country is heavily influenced by the extent of competition within the host country market. Yeoman found, for example, that the more price elastic the demand for a U.S.-based multinational's products in a low-wage country (i.e., the greater the price competition faced by the firm), the more the production techniques employed by the firm in that country differed in labor intensity from the techniques employed by the same firm in the United States.[38] Wells has shown that foreign-owned firms that compete primarily on the basis of price in a developing country are more likely to use labor-intensive techniques than those

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38 Wayne A. Yeoman, "Selection of Production Processes for the Manufacturing Subsidiaries of U.S. Based Multinational Corporations," D.B.A. thesis, Harvard Business School (Boston, 1968).

that compete primarily on the basis of brand names.[39] Furthermore, multinational enterprises that have set up "offshore" production facilities to export textiles or electronics to developed country markets have generally been driven by price competition to locate their labor intensive stages in the Third World. This suggests that, to the extent host country authorities can encourage competition (among foreign investors or between foreign investors and local firms) in their domestic markets, they can achieve better results from multinational firms in terms of labor-intensive production technologies. And the more efficient use of local resources could be facilitated by allowing economic, rather than prestige, considerations to dictate host country policy toward the importation of "old style" or second-hand equipment.

Furthermore, once the development of such technologies is stimulated in one part of a multinational system, their use may spread rapidly throughout the corporations' network in the Third World. Ford's low-cost "modern Model T" (the Fiera), for example, is designed to be produced in small job shops where brake presses and simple welding jigs replace the stamping dies and automated equipment that make upwards of two hundred welds simultaneously in Ford's U.S. plants. The company decided to experiment with this type of production technology explicitly so that it can be introduced throughout the Asia-Pacific region if it is successful in the first plant in the Philippines.

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39 Louis T. Wells, Jr., "Economic Man and Engineering Man: Choice in a Low-Wage Country," Public Policy, Vol. XXI (1973).

A related issue is whether multinational corporations influence, alter, or pervert the tastes and cultural values of the host country. Clearly, as foreign companies try to expand the market for "home country" products in the Third and Fourth Worlds, their advertising strategies will portray in a positive light the same affluent tastes and high consumption ethic that exist in the host country. Conversely, the advertising strategy may tend to denigrate local customs -- urging, for example, formula feeding of infants rather than breast feeding, or mechanized, high-fertilizer, high-pesticide farming rather than intensive (conventional) agricultural production.

There is no reason to predict, nor is there evidence to demonstrate, however, that the marketing efforts of foreign firms incorporate norms, or portray those norms more effectively, than do local firms that also profit from high consumption patterns. Thus the issue that local authorities confront is not so much a particular question of cultural dependencia as it is a general question of "protecting" the local population in accordance with the norms of those authorities or of a particular group of their constituents. The options for public policy in this area range from the relatively easy (e.g., a governmental requirement for all firms to prove the benefits claimed in their advertising, or a public campaign to extol the advantages of alternatives to what is promulgated in local advertising) to the more difficult (e.g., a governmental effort to stop the adulation of a high consumption lifestyle). While most countries have found the latter to be unacceptably

intrusive into the private lives of their citizens, democratic governments (Norway, Oregon) as well as undemocratic governments (Burma, Albania) have begun to consider seriously how to limit the spread of affluent or wasteful or environmentally dangerous patterns of living. The exchange of information about successful policies in these states could provide Third and Fourth World governments with a variety of tools to strengthen values that they consider worthy of preservation.

The final issue with regard to employment is the possible creation of positive externalities. The extent to which the investment in training undertaken by the firms spills over into the rest of the economy may constitute a sizable benefit to the host country. The picture, in practice, appears quite mixed on this issue. There is significantly higher turnover at the production worker level than of management personnel.[40] Thus there are sizable gains to the host country from the training of production workers, but the firms internalize to a much greater extent the benefits resulting from their investment in entrepreneurs and engineers.

Multinationals and Distribution of Income

Neoclassical theory predicts that direct foreign investment will tend to equalize rather than concentrate income in the host country by creating new jobs (more than it displaces), by raising the demand for labor (and hence its wages), and by lowering the return to capital.

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40 Reuber, op.cit., p. 173.

To arrive at this conclusion, neoclassical analysis makes two basic assumptions: that foreign investment adds to total domestic investment, and that foreign and domestic producers utilize technologies that are equally labor-intensive. Both assumptions have been challenged, however; if they do not hold, the impact of multinational activities on local income distribution becomes potentially negative.

There are two reasons why multinational corporations might not add to domestic capital formation: they may borrow locally themselves rather than bringing "new" capital into the country, and/or they may monopolize the best investment opportunities in the host country to the detriment of state companies and private capitalists, inducing the latter to send their capital abroad (licitly or illicitly) rather than investing in unpromising projects at home.[41] It is sometimes hypothesized, in fact, that the two effects reinforce each other, on the view that foreign firms enjoy preferential treatment in borrowing locally from host country financial institutions. In periods when Third World (like all) governments restrict credit markets to control inflation, the foreign subsidiaries get a more generous ration of loans to expand their operations than do domestic firms. In periods of economic contraction, when financial institutions are hesitant to roll over the loans of businesses that could go bankrupt, the foreign subsidiaries receive more sympathetic service than their domestic counterparts. Thus multinationals have a comparative advantage in borrowing locally, which

41 A. Hirschman, How to Disinvest in Latin America and Why, Essay in International Finance No. 76 (Princeton, N.J.: Princeton University Press, 1969).

reduces their need to bring capital into the country and reinforces their ability to capture the best domestic investment opportunities.

There have been no systematic efforts to test whether multinationals enjoy preferential treatment on the part of local financial institutions. Foreign sources almost certainly provide a net addition to the capital stock of host countries and hence have a progressive effect on income distribution, but it is clear that external investors generate a large proportion of their capital requirements locally. From 1958 through 1972, funds from the United States represented only 21-22 percent of the total use of funds by majority-owned foreign affiliates of U.S. enterprises (MOFAs) in Latin America and in all developing countries (Tables 5 and 6. Data for all developing countries are available only for 1966-72.) Some of the other foreign funds were raised in third countries, but some were local -- multinationals frequently try to maximize their liabilities in local currency to balance their exchange risks there. Some of the funds generated through retained earnings and depreciation can be regarded as foreign, but a large share of them should be regarded as local. Data shortcomings preclude adequate analysis of this issue, but a good deal of "foreign" investment -- perhaps as much as 50 percent -- appears to be financed from local savings.

The possibility of an adverse effect on income distribution from foreign investment also occurs if the foreign investment is more capital-intensive than domestic investment (as discussed in the previous

Table 5

U.S. MANUFACTURING IN LATIN AMERICA 1958-1965: SOURCES OF FUNDS

(In millions of dollars)

	Total	Retained earnings	Depreciation	Funds from United States	Funds from other non-U.S. sources
1958	340	63	60	67	150
1959	367	77	70	70	150
1960	559	46	80	125	308
1961	489	92	206	86	105
1962	526	117	147	152	110
1963	586	128	125	158	200
1964	995	191	191	155	478
1965	1,225	228	217	285	458
Total	5,087	942	1,096	1,098	1,959
			(In percentages)		
1958	100	19	18	20	44
1959	100	21	22	19	41
1960	100	16	13	21	51
1961	100	19	42	18	21
1962	100	22	28	29	21
1963	100	22	34	23	21
1964	100	19	48	16	19
1965	100	19	37	23	18
Total	100	19	22	22	39

Source: Survey of Current Business, November 1970, August 1963, September 1961.

Table 6

U.S. INVESTMENT IN MANUFACTURING: SOURCES OF FUNDS, 1966-72

(In percentages)

All developing countries	Retained earnings	Depreciation	Other	U.S. funds	Debt from affiliate	Debt from foreign sources	Foreign equity
1966	25	25	-2	20	4	26	2
1967	12	32	-5	25	2	29	4
1968	18	21	1	8	2	44	4
1969	15	24	-	31	1	27	3
1970	7	33	3	13	7	36	2
1971	13	40	9	21	-4	24	-4
1972	13	22	-	24	2	37	2
Total	14	27	1	21	2	33	2
Latin America							
1966	32	29	-1	9	1	30	1
1967	11	40	-8	23	3	27	4
1968	17	23	-	9	3	44	4
1969	14	24	-	33	1	26	2
1970	2	33	4	14	5	40	3
1971	13	48	11	23	-7	19	-7
1972	12	21	-	26	-	39	2
Total	14	31	1	19	1	34	1

Source: Survey of Current Business, July 1975.

section) and if there is chronic unemployment in the host country labor market. Under the usual neoclassical assumption of full employment, foreign investment (whether it is more capital-intensive or not) increases the efficient use of host country resources and "frees" the labor it may displace for more productive activity elsewhere in the economy. If there is permanent unemployment or underemployment in the host country, however, a capital-intensive foreign investment may bid up the wages for a domestic skilled labor elite, which is frequently in short supply, while consigning a greater number of workers to the ranks of the marginalizados.[42]

The two effects just discussed -- the net effect of foreign direct investment on the local capital stock, and differences in capital intensity between the two types of investment -- must be combined to assess the impact of foreign direct investment on income distribution in the host country. If there is no net capital inflow, and if the multinationals have a higher capital-labor ratio, then the impact would be negative. It is much more likely, however, that there is enough net inflow to most host countries to offset any tilt toward capital intensity. But there is no solid empirical basis for judgment at this point in time. And it is doubtlessly true that foreign direct investment could contribute more than it now does to better income distribution in LDCs, by bringing in a greater share of the capital

42 See William R. Cline, "Distribution and Development: A Survey of the Literature," Journal of Development Economics, Vol. 1 (1975), p. 372.

used in its projects and by using more labor-intensive production techniques.[43]

Numerous factors influence national income distribution patterns, of course, and foreign direct investment is unlikely to have a decisive impact. In the United States, for example, we have been unable to discover any effect whatsoever from its role as a home country of multinationals.[44] Among host countries, there is no apparent relationship between per capita investment levels and domestic income structure (Table 7). Two countries whose income distribution has improved most rapidly (Taiwan and Sri Lanka) have hosted relatively little foreign direct investment on a per capita basis.[44a] But two other countries (India and Korea) which have hosted relatively low levels of per capita foreign direct investment have experienced a deterioration in income distribution. And two other countries (Venezuela and Panama) which have experienced deterioration in their patterns of income distribution have hosted the largest per capita levels of foreign direct investment in the less developed world. Of the six countries where income

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43 It also appears that local equity plays a small role in providing local savings (Table 6). Debt seems to have been predominant. This probably limits the return to local investors from the capital which they provide to multinational enterprises. Multinationals could contribute more to host country income by obtaining a greater share of their local financing through equity issues.

44 See Chapter 4 of American Multinationals and American Interests. On both theoretical and empirical grounds, we reject the view that foreign direct investment by U.S.-based firms has skewed the distribution of U.S. income against American labor.

44a However, they have had wholly different approaches to the issue in recent years: Taiwan has generally welcomed such investment, while Sri Lanka has discouraged it.

Table 7

FOREIGN DIRECT INVESTMENT AND INCOME

DISTRIBUTION IN SELECTED DEVELOPING COUNTRIES

	Upper 20%	Middle 40%	Lowest 40%	Foreign direct investment per capita (in dollars)
	(Rate of income growth)			
Improving income distribution				
1. Taiwan (1953-61)	4.5	9.1	12.1	11
2. Sri Lanka (1963-70)	3.1	6.2	8.3	12
3. Colombia (1964-70)	5.6	7.3	7.0	36
4. El Salvador (1961-69)	4.1	10.5	5.3	24
5. Philippines (1961-71)	4.9	6.4	5.0	21
6. Peru (1961-71)	4.7	7.5	3.2	62
Deteriorating income distribution				
7. Panama (1960-70)	8.8	9.2	3.2	586
8. Korea (1969-70)	10.6	7.8	9.3	3
9. Brazil (1960-70)	8.4	4.8	5.2	41
10. India (1954-64)	5.1	3.9	3.9	3
11. Mexico (1963-69)	8.0	7.0	6.6	36
12. Venezuela (1962-70)	7.9	4.1	3.7	357

Source: Data on income distribution are from Hollis Chenery, Redistribution with Growth: Policies to Improve Income Distribution in Developing Countries (London: Oxford University Press, 1974). Data on foreign direct investment are from Reuber, op.cit.

distribution deteriorated, all three possible patterns of foreign direct investment were present: two were among the highest recipients, two were among the lowest, and two (Brazil and Mexico) were in the middle.

Finally, to make a judgment about the net impact of foreign investment on host country income distribution, one must include an examination of how the host government utilizes its potential bargaining power vis-a-vis the foreign firms. It may use performance requirements -- such as job quotas and technology transfer demands -- and tax revenues to support welfare and development projects that equalize domestic income. Or it may use them to subsidize the middle and upper classes, or the military, in ways that worsen domestic income distribution. As Adelman and Morris have concluded, explicit governmental policies seem necessary to improve income distribution -- whatever the constellation of other economic forces, such as foreign direct investment.[45] As noted above, it appears likely that foreign direct investment promotes better income distribution in host countries -- but that government policy as well as the firms themselves could heighten that contribution.

Empirical Results: The Balance of Payments

A bit more work has been done on the impact of foreign direct investment on the balance-of-payments positions of developing countries, as already noted in our reviews of Bos and Streeten. Here there are two

45 Irma Adelman and Cynthia Taft Morris, Economic Growth and Social Equity in Developing Countries (Stanford: Stanford University Press, 1973).

issues: the effect on the capital account, which encompasses the initial capital inflows and subsequent repatriation of earnings, and the effect on the trade account through both import substitution and promotion of exports. In both components, the issue of "what is the alternative" looms extremely important, because it is clear that many developing countries now can obtain capital from the external debt market and that many local firms now can compete in world markets.

The capital flow analysis proceeds by comparing capital inflows generated by the firm with remittances from the subsidiary. If the latter is greater than the former, it is asserted that direct investment causes a strain on the balance of payments of the host country. For all foreign direct investment in developing countries, income paid to the United States has far exceeded capital inflows from the United States due to the petroleum sector (Table 8).

For manufacturing, however, net flows from the United States exceeded repatriations to the United States by $570 million for Latin America and by over $100 million for other developing countries from 1966 through 1974 (Table 9). Annual outflows exceeded annual repatriations in virtually every year. But dividend income represents only one of the mechanisms by which income repatriation is accomplished. Counting management fees and royalty payments, to obtain a broader measure of income repatriation, tilts the balance toward net LDC outflows even in manufacturing, except for Latin America in 1974.

Table 8

U.S. FOREIGN DIRECT INVESTMENT IN ALL INDUSTRIES

IN DEVELOPING COUNTRIES: 1960-74

(in millions of dollars)

	Latin America		Other developing areas	
	Net capital outflows	Balance-of-payments income	Net capital outflows	Balance-of-payments income
1966	303	1,017	196	929
1967	311	1,120	446	1,051
1968	708	1,186	444	1,244
1969	385	1,237	412	1,415
1970	579	967	405	1,372
1971	696	1,061	606	1,651
1972	272	915	860	2,164
1973	659	1,520	266	3,209
1974	3,908	9,023	3,635	13,035

Source: Survey of Current Business, Oct. 1975.

Table 9

U.S. FOREIGN DIRECT INVESTMENT IN MANUFACTURING IN DEVELOPING COUNTRIES: 1960-74

(In millions of dollars)

	Latin America				Other developing areas			
	Net capital outflows	Reinvested earnings	Balance-of-payments income	Fees and royalties	Net capital outflows	Reinvested earnings	Balance-of-payments income	Fees and royalties
1966	187	174	108	80	50	25	24	15
1967	197	83	141	95	68	33	27	26
1968	275	209	164	112	33	31	40	19
1969	215	263	171	105	71	58	35	17
1970	132	259	205	116	25	63	43	25
1971	228	246	208	116	56	50	50	27
1972	288	364	236	124	35	71	53	22
1973	360	476	275	135	83	143	78	51
1974	503	534	304	147	105	170	74	45
Total	2,385	2,608	1,815	1,030	526	655	424	267

Source: Survey of Current Business, Oct. 1975.

Critics of this approach argue that it is illegitimate to compare inflows of new investment with outflows of earnings on all past investments. If the investment is profitable, income generated by it will always exceed the initial capitalization. In addition, it is argued that retained earnings should be included in capital inflows to the host country. As is clear from Columns 2 and 6 of Table 9, adding retained earnings makes the inflows to developing countries exceed outflows from them.

These arguments, however, ignore the focus of the critics on the acquisition of foreign exchange by the host country. Since capital inflows and outflows are in hard currency, the issue for a host country is whether it can limit the repatriation of earnings from past investments and maximize new capital inflows without deterring desired new investment. In both cases, multinationals could contribute more to development than they now do.

The contribution of manufacturing foreign direct investment to the host country's balance of payments (and development

generally) needs to be adjusted by the extent to which LDC investment was not undertaken due to the fact that local capital was thereby made unavailable. Sales, employment, tax revenue and the other macroeconomic effects of foreign direct investment would all have to be substantially reduced since perhaps one-half of the capital utilized to undertake foreign direct investment is local, and consequently does not represent an addition to the available stock of capital (unless it would otherwise have been exported). The projects undertaken by the LDC may not be as productive as those undertaken by multinational enterprises, but the true benefits would then be only the difference in productivity of the two projects (as estimated in the case studies of Streeten, cited above, which utilize such a methodology).

In addition, 44 percent of the manufacturing subsidiaries formed in Latin America from 1958 to 1967 were acquisitions. Evidence for individual countries indicates that this phenomenon gained impetus in subsequent years, but even the totals for all subsidiaries formed prior to 1967 are strikingly high. The majority of firms acquired in Brazil and Mexico, the only countries for which detailed data are available, are profitable -- sometimes highly profitable.[46] This acquisition of profitable firms represents one mechanism by which multinational enterprises tap local savings, reducing further the extent to which retained earnings can be viewed as capital inflows

46 Newfarmer and Mueller, op.cit., pp. 70 and 123. They estimate that the growth in MOFA assets accounted for by acquisition over the period 1960-1972 was 19.8 percent in Mexico and 23.9 percent in Brazil.

to the host country which increase the contribution of foreign direct investment to its balance of payments.

The final balance of payments question is whether multinational enterprises increase host-country exports and/or save on imports, thereby earning or economizing on the use of foreign exchange. De la Torre, Reuber and Vernon utilized preliminary versions of the benchmark data for 1966 to argue that export sales of the multinational enterprise increased substantially, both in absolute and relative terms, over the period 1957 to 1966.[47] An examination of the revised data raises serious doubts about this conclusion, however, particularly with regard to Latin America. After rising from 4.2 percent of their total sales in 1957 to 6.2 percent in 1966, exports by U.S. manufacturing MOFAs in Latin America has remained relatively constant (Table 10). The annual growth rate of exports of manufactures by Latin America for the period 1966-1970 was 28 percent,

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47 Reuber, op.cit.; J. De la Torre, "Foreign Investment and Export Dependence," Journal of Economic Development and Cultural Change, October 1974. R. Vernon, Sovereignty at Bay (New York: Basic Books, 1971), Chapter 3.

Table 10

DISTRIBUTION OF SALES OF U.S. MANUFACTURING MOFA, BY DESTINATION
(In percent)

	Local sales	Exports
1957	95.79	4.21
1966	93.82	6.18
1967	93.57	6.43
1968	94.41	5.59
1969	94.82	5.18
1970	94.74	5.26
1971	94.15	5.85
1972	93.76	6.24
1973	93.90	6.10

Source: Survey of Current Business, August 1975 for 1966-73. The 1957 figure comes from the benchmark study for that year.

Table 11

GROWTH OF MANUFACTURING EXPORTS[a]: 1966-1970

(In millions of dollars)

	Area totals			U.S. MOFAs		
	1966	1970	Growth rate (%)	1966	1970	Growth rate (%)
All LDCs	5,618	9,628	14.41	311	807	26.92
Latin America	688	1,855	28.14	162	305	11.12
Asia	3,424	4,943	9.50	151	427	29.68

a/ SITC 5-8 less 68 (nonferrous metals). Manufacturing exports usually contain processed food products but in this case they have been eliminated from both portions of the table.

but the growth rate of MOFAs in Latin America was only 11 percent.[48] (See Table 11. Since exports of MOFAs are included in the total, exports of local firms and non-U.S. multinationals, taken together, are growing much faster than 28 percent.) The share of MOFA exports in total Latin American manufactured exports, referred to by earlier authors as being as high as 40 percent, fell from 23.6 percent in 1966 to 16.4 percent in 1970. And, as noted above, Streeten found that the export performance of firms included in his six-country study was unimpressive.

The export performance of U.S. MOFAs has been much stronger in the so-called export platforms. Their Asian exports rose annually by almost 30 percent during 1966-70, compared with less than 10 percent for the region as a whole. On the other hand, for more recent years, Cohen has shown that host-country firms were as successful as MOFAs in expanding exports of many manufactured goods in Taiwan and even did better in Singapore, though MOFAs did better in Korea.[49]

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48 For similar conclusions see Richard D. Morgenstern and Ronald E. Müller, "Multinational Versus Local Corporations in LDC's: An Econometric Analysis of Export Performance in Latin America," Southern Economic Journal, Vol. 42, No. 3 (January 1976), pp. 399-406.

49 Benjamin I. Cohen, Multinational Firms and Asian Exports (New Haven and London: Yale University Press, 1975), p. 138. At the same time, MOFAs also imported more of their inputs than did local firms in Korea, while importing less in Taiwan and about the same share in Singapore. Value-added by local firms was higher in Korea, about the same in Taiwan and Singapore. Cohen concludes (p. 119) that "neither the direct nor the indirect benefits of this type of foreign investment are very great, if they exist at all." Cohen's sample is rather small, however. He analyzed only 9 products and 49 firms. In addition, his products are fairly standardized and labor-intensive. Export performance from LDCs by multinational enterprises may be better in the case of more sophisticated products, for which their experience and expertise may prove more valuable. The whole question of manufactured exports and multinational enterprises requires a good deal more empirical work, at both the case-study and macroeconomic levels.

A final issue concerning the trade effects of multinational enterprises concerns the role of intrafirm transactions and pricing. Intrafirm trade and transfer pricing have the potential to serve as further mechanisms by which funds may be moved in and out of individual countries. If the firms overprice their imports and underprice their exports as a means of transferring funds, the LDC would lose foreign exchange despite increased exports or reduced imports.

Unfortunately, as in the case of most of the issues discussed here, there are simply inadequate data to permit judgment on the magnitude of the phenomenon. Manipulative pricing is difficult to detect in any event owing to the absence of an existing arm's-length price. Administratively, the volume of goods is so sizable that effective monitoring may be difficult in any event. Brooke and Remmers argue that manipulative transfer pricing is viewed by the firms only as an emergency device primarily due to the sizable risks if caught.[50] And the U.S. Treasury has charged numerous U.S.-based multinational enterprises with transfer pricing their profits out of the United States.

Nevertheless, the potential significance of the practice, given the amount of intracompany trade, is clear. $7.7 billion in sales by U.S. manufacturing subsidiaries located in developing countries went to other members of the firm as early as 1966. 68 percent of export

50 M. Z. Brooke and H. L. Remmers, The Strategy of Multinational Enterprise (New York: American Elsevier Publishing Co., 1970).

sales are intracompany. Imports of subsidiaries from their parents were nearly $4 billion in 1966. This issue too thus needs much further research.

An Assessment

This review indicates serious limitations in existing knowledge concerning the impact of foreign direct investment on development. The bulk of economic theory and the limited empirical work which has been done suggest that its aggregate effects are usually positive on national income, jobs and government revenues in the host countries. However, the contribution of the firms to development on these criteria could clearly be improved further both through actions of their own (e.g., adaptation of their production processes to local factor proportions), better host-country policies toward investment itself (e.g., reduced incentives to capital-intensive processes, fewer general tax incentives, minimum job quotas), and better general host-country policies (e.g., toward better income distribution). And major doubts are raised about the impact of foreign direct investment on both the capital and current accounts of LDC balance-of-payments positions.

These conclusions, along with the dominance in the foreign investment process of oligopolistic firms and increasingly assertive host countries, combine to indicate that the contribution of foreign direct investment to development will turn increasingly on explicit negotiations between firms and host governments. Virtually every country now actively negotiates entry

contracts and performance requirements with incoming foreign firms.[51] Hence the net benefits of foreign direct investment for developing countries are undoubtedly rising relative to the past. At the same time, however, these countries have increasing access to the array of inputs provided by multinational enterprises in unbundled form: external debt capital, licensing of technology, and management contracts. Hence they need multinational enterprises less than they did in the past.

This new situation poses fundamental issues for policy in the United States, and indeed other home countries of firms which invest in the Third and Fourth Worlds. Even the poorer host countries are increasingly able to fend for themselves, both attracting manufacturing multinationals and in harnessing them to host-country objectives. Indeed, their ability to do so in some cases raises the specter of real economic costs to the home country.[52]

At the same time, the economic and social problems faced by many developing countries remain staggering. Accelerated in recent years by the increased price of oil and world recession, these problems may even have intensified. And the traditional tools by which the rich countries have helped the poor, notably concessional foreign assistance, have become increasingly unpopular in the United States. Hence there

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51 See American Multinationals and American Interests, esp. Chapter Ten, and the detailed entry requirements in thirteen countries outlined in Richard D. Robinson, "National Efforts to Establish Guidelines for the Behavior of Multinational Corporations," A Study Prepared for the U.S. Department of Labor, 1975.

52 C. Fred Bergsten, "Coming Investment Wars?" Foreign Affairs, October 1974.

is an increased proclivity to turn to other instruments, including foreign direct investment, to provide such help. We turn now to a review of U.S. policy, and suggestions of possible changes to meet the new set of circumstances.

UNITED STATES POLICY

Throughout the postwar period, U.S. policy toward the development aspects of foreign direct investment has been based on the neoclassical view that it generally promotes welfare in both the home and host country. Such investment has been viewed as helping development in the recipient countries, and at the same time as supporting (or at least not hurting) U.S. economic objectives. Hence the United States has sought maximum international mobility of capital. The most explicit manifestations of that approach have been tax policies which avoided discrimination against foreign source income, liberal trade policies and programs designed to reduce the risks of investment in the less developed countries. Most of the tax and trade policies apply equally to investment in all foreign countries, but a few have provided preferential treatment for the poorer countries.

There have been two significant exceptions to this approach, however. One is the investment tax credit (ITC), which applies only to investment in the United States and hence discourages foreign direct investment. The second was the balance-of-payments control program of 1965-74, which placed sharp limits on the amounts of U.S. capital which could

be exported to finance foreign direct investment by firms based in the United States. In this section, we will seek to assess the effects of these different policies on the contribution of U.S. foreign direct investment to development, and suggest steps which could improve that contribution.

Taxation of Foreign Income: The Credit and Deferral

By far the most important U.S. policy toward foreign direct investment has been its tax treatment of income derived from foreign sources. For purposes of this paper it is useful to distinguish among three facets of the tax code: those which relate to all foreign source income, those specificially applicable to less developed areas, and those designed to deal with expropriations (which have their primary impact in such areas).

Tax incentives to direct investment in the LDCs should rest on four basic criteria.[53] First, the incentive must be sizable in order to affect in any meaningful way the geographical composition of U.S. investment -- both the choice between domestic and foreign investment in general, and the choice between developing and developed regions. Most observers of foreign direct investment have concluded that small differences in tax rates play little, if any, role in the initial decision to venture abroad. Our own analyses, as reported below, suggest relatively small effects even from tax changes regarded as

53 The first three are discussed by R. Hellawell, "United States Income Taxation and Less Developed Countries: A Critical Appraisal," Columbia Law Review, Vol. 61, No. 8 (Dec. 1966).

major by the U.S. business community. In the case of most developing countries, a marginal difference in rates of return is particularly unlikely to compensate for the higher risk involved in investing there.

Second, any incentive should be temporary. The objective is "infant industry" support for new industries in developing countries, not a permanent subsidy. In addition, the effectiveness of tax policy in stimulating foreign direct investment in the LDCs is uncertain; incentives might turn out to be wasteful subsidies, in practice, and their cost-benefit ratios should be constantly reviewed to see whether the payoff is as expected. And, preferential treatment for LDCs of course violates the notion of tax equity, which purportedly underlies most U.S. tax law; here the violation is particularly important since the incentive would be quite sizable and would favor (a) foreign investment over domestic investment and (b) foreign direct investment in LDCs over foreign direct investment in industrialized countries. Such incentives should be set for limited periods, for all these reasons, albeit with possibilities for renewal if the particular situation warrants.

Third, a great deal of selectivity should be built into any incentive for direct investment in the LDCs. Such selectivity should be of three types: geographic, industry, and process. Geographic selectivity is needed because there is a rising middle class of developing countries, such as Mexico and Brazil, for which subsidies to U.S. direct investors

may no longer be necessary. Yet most U.S. tax policies at present do not even distinguish between industrialized and developing countries. From a development standpoint, they should make not only that distinction but a further distinction between the Third and Fourth Worlds. If extended to the Third World at all, any preferential tax treatment could be limited to poorer regions within those countries (such as the Brazilian Northeast).

Industry selectivity is needed because the available data, as discussed in the first section of this paper, suggest that generalized support of foreign direct investment may well waste resources in both the home and host countries. It is necessary to focus on those sectors where foreign direct investment can contribute most clearly to the host country's development goals. Tax policy could contribute to diverting investment toward those sectors which are most likely to create new jobs, improve income distribution, and generate exports.

Finally, process selectivity would permit tailoring the incentive to explicit development goals. For example, it could favor labor-intensive techniques and other types of investment which improve income distribution. There is obviously some overlap between industry and process selectivity, but different production processes are clearly available within some industries and hence sub-industry differentiation is possible.

Fourth, the cost of the incentive should be largely borne by the home country. We shall see that some present U.S. tax policies support

investment in the developing countries only by virtue of ratifying host-country tax incentives, with the real cost of the incentives falling largely on the host countries. Let us test current U.S. tax policy against these four criteria.

Present U.S. treatment of foreign-source income rests primarily on the foreign tax credit and the deferral of any taxation on such income until it is repatriated to the United States. The foreign tax credit was initially incorporated into the U.S. tax code in 1913. Faced with the alternative of completely exempting foreign source income from U.S. taxes, or permitting foreign taxes to be treated only as a deduction, a compromise emerged which permitted firms to credit their foreign income tax payments (and payments of other direct, but not indirect, foreign taxes) against their U.S. tax liabilities on their foreign income.

Thus in the early stages of corporate taxation the United States chose a system which embraced "capital export neutrality." In such a system, taxation is not supposed to play a role in the investor's choice between domestic or foreign investment. Investment projects are to be ranked in terms of their gross (pre-tax) rate of return, on the grounds that this is the best mechanism for allocating capital worldwide.[54] In both of the alternative regimes, taxes by contrast, play a major role in the allocation of capital. Foreign investment is favored if there is no taxation of foreign income, while domestic investment is

54 Table 12 compares the tax burdens on two investments, one foreign and one domestic. Despite the lower tax rate of the foreign country, the total tax burden on both investments is identical.

Table 12

A SIMPLE EXAMPLE OF THE FOREIGN TAX CREDIT

	Domestic investment	Foreign investment
Income	10,000	10,000
Foreign tax rate	na	30%
Foreign tax	na	3,000
Earnings after foreign tax	na	7,000
Dividend to parent	na	7,000
U.S. tax rate	50%	50%
Pre-credit U.S. tax	5,000	5,000
Credit for foreign taxes	na	3,000
U.S. tax paid	5,000	2,000
Total tax paid	5,000	5,000
Effective tax rate	50%	50%

na - not applicable

avored if foreign tax payments can only be deducted from foreign income rather than credited against U.S. tax liabilities on that income.[55]

To what extent has the U.S. regime of modified capital export neutrality,[55a] implemented via the foreign tax credit, promoted direct investment in the developing countries? Utilizing the findings of the microeconomic model underlying the tax analysis in Chapter Six of American Multinationals and American Interests, we can obtain an

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55 Table 13 contrasts the three approaches. The deduction of foreign taxes from taxable income, rather than crediting foreign tax payments against domestic tax liabilities on foreign income, is called "national neutrality" by its proponents. They argue that, from the point of view of the U.S. national interest, the relevant comparison when ranking investment projects should be the U.S. pre-tax rate of return and the foreign post-tax rate of return, since foreign taxes are paid to non-U.S. citizens.

55a Though the foreign tax credit goes far toward achieving capital export neutrality, it falls short of achieving pure neutrality since the United States permits a credit only to the extent of the firm's tax liability in the United States on its foreign income. Achievement of pure capital export neutrality would necessitate allowing the firms to credit their foreign tax payments against the tax liabilities on their domestic income, and even extending rebates to firms in the event that their foreign taxes exceeded their total U.S. tax liabilities on all income. Obviously a regime of pure capital export neutrality would be an invitation for host countries to substantially increase their income taxes, since such increases would then have no effect on the firms. In order to preserve its tax revenues, no home country would permit unbridled capital export neutrality. The United States certainly does not do so.

Table 13

ALTERNATIVE MEANS OF TAXING FOREIGN INCOME[a]

	Credit	Exemption	Deduction
Income	10,000	10,000	10,000
Foreign tax rate	30%	30%	30%
Foreign tax	3,000	3,000	3,000
Dividend to parent	7,000	7,000	7,000
Pre-credit U.S. tax	5,000	0	3,500
Tax credit	3,000	0	0
U.S. tax paid	2,000	0	3,500
Total tax paid	5,000	3,000	6,500
Effective tax rate	50%	30%	65%

na - not applicable

a/ assuming 100% repatriation of profits, with grossing up and 50% U.S. tax rate.

approximation of the differences in the flow of U.S. foreign direct investment which might result under a regime of national neutrality (i.e., deduction rather than crediting of foreign taxes) instead of the foreign tax credit. Assuming that the geographic distribution of foreign direct investment -- about 18 percent of manufacturing investment goes to LDCs -- would not be altered by elimination of the credit, we estimate that the flow of foreign direct investment into manufacturing industries in developing countries would fall by over 50 percent, or over $1.5 billion at the 1974 level of investment. If repatriation of existing foreign capital to the United States were precluded because of the prohibitive tax treatment thereof which would result from eliminating the credit, direct manufacturing investment in developing countries would still fall by about 3.5 percent, or a bit over $100 million at the 1974 level of investment. (This assumes that deferral, as discussed below, was also eliminated.[56]) These estimates reveal the significant role that a commitment to capital export neutrality has played in promoting direct investment in the LDCs. The broad reasons for which the credit was adopted remain valid, and it should be retained.[57]

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56 Such an assumption seems reasonable, since the credit is the more important of the two and deferral would almost certainly fall first to attacks on the current tax system.

57 The major controversy concerning the implementation of the tax credit, until recently, was its treatment of royalty payments made by U.S. oil companies in the Middle East. The standard rule is that only direct taxes, primarily income taxes, can be credited. In the early 1950s, however, the Treasury -- directed by the National Security Council, to promote U.S. relations with Saudi Arabia and Iran essentially by extending them massive amounts of back-door aid -- permitted the crediting of royalties. These credits, coupled with branch losses, effectively reduced the U.S. tax liability of the oil companies to miniscule levels. Such treatment was barred for the future in the Tax Reduction Act of 1975.

In calculating the foreign tax credit, the United States permits a firm to choose one of two methods: the overall or the per-country. The firm will of course choose the option which maximizes its allowable credits and thus minimizes its total tax burden. The availability of this choice moves the United States toward, if not fully to, pure capital export neutrality.

Under the overall technique, the firm calculates the total direct taxes paid to all foreign jurisdictions in which it is active and applies this credit against U.S. tax due on its total foreign income. The alternative per-country limitation entails a separate credit calculation for each national jurisdiction in which the firm operates. The overall approach is invariably chosen by manufacturing companies, since it permits the use of excess credits generated in high tax countries to offset the smaller credits generated in low tax countries (see Table 14).

The overall option constitutes a significant incentive for investments in low-tax (including developing) countries for firms with existing excess tax credits and/or large investments in high-tax countries. At the same time, it constitutes an incentive to invest in high-tax (largely industrialized) countries for firms which already have large investments in low-tax areas. This is because the high tax payments in such countries can be netted against the existing low payments, with no increase in global tax payments by the firm, and the high tax rates thus lose their usual impact in deterring investment. On balance, the option seems to have a significant impact: the U.S. Treasury estimates that its elimination would

Table 14

OVERALL VERSUS PER-COUNTRY LIMITATION

Country A tax rate 35%
Country B tax rate 60%
U.S. tax rate 50%

Subsidiary 1 and Subsidiary 2 both earn 10,000.

Total foreign income 20,000
Country A tax 3,500
Country B tax 6,000

	Overall limitation		Per-country limitation
Income	20,000		20,000
Pre-credit U.S. tax	10,000		10,000
Credit limit $10{,}000 \times \frac{20{,}000}{20{,}000}$	10,000	Country A $10{,}000 \times \frac{10{,}000}{20{,}000}$	5,000
		Country B $10{,}000 \times \frac{10{,}000}{20{,}000}$	5,000
Credit taken	9,500	Country A	3,500
		Country B	5,000
Net U.S. tax	500		1,500
Total tax	10,000		11,000
Unusable credits	--		1,000

bring in $200-265 million annually in additional tax revenues, primarily from low-tax countries.[58]

More broadly, the availability of the overall option may induce behavior on the part of the firm which is detrimental to both the home and the host country. In both cases just outlined, the investment of capital largely for tax purposes represents sub-optimal allocation. In addition, its existence induces firms with existing or prospective excess credits to manipulate their transfer pricing to shift income from high-tax to low-tax countries in order to minimize overall tax liabilities. On the other hand, the overall option is administratively simpler and represents a move toward greater capital export neutrality.

From a development perspective, the overall option is a mixed blessing. It generally promotes investment in low-tax countries, which gives LDCs an opportunity to utilize incentive systems. It also promotes transfer pricing to such countries which may help them if their own tax authorities are skillful enough to capture some of the

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58 Department of the Treasury, U.S. Taxation of the Undistributed Income of Controlled Foreign Corporations, April 1976, p. 61. The analysis assumes simultaneous elimination of the deferral provision, to be discussed below. Developing countries have no monopoly in levying "low taxes" (see Table 15), but their share of the impact of eliminating the overall option would probably be greater than their overall share of U.S. foreign direct investment.

Table 15

TAXES PAID TO SELECTED FOREIGN GOVERNMENTS

BY U.S. MULTINATIONALS

(% of taxable income)

1.	INDIA	66.2
2.	PHILIPPINES	51.3
3.	France	49.8
4.	Germany	49.1
5.	New Zealand	48.9
6.	PERU	48.4
7.	MEXICO	47.7
8.	Norway	47.2
9.	Canada	46.2
10.	Sweden	45.3
11.	CHILE	44.5
12.	Australia	44.3
13.	Japan	43.4
14.	United Kingdom	43.4
15.	Italy	43.3
16.	BRAZIL	41.3
17.	South Africa	41.3
18.	Belgium	37.7
19.	Netherlands	36.9
20.	Denmark	35.0
21.	VENEZUELA	33.3
22.	ARGENTINA	27.4
23.	Switzerland	23.9
24.	PANAMA	21.4

Source: American Multinationals and American Interests, Chapter 6.

resulting benefits to the firms. Hence its elimination by the United States would probably be viewed as a hostile act by developing countries unless something of equal magnitude were put in its place.

However, the "incentive races" promoted by the overall option are themselves a mixed blessing, in view of the uncertain developmental effects of undifferentiated foreign direct investment. In addition, this particular tax provision violates at least three of the criteria outlined above which should underlie tax incentives for investment in poorer countries: it is permanent rather than temporary, it is general rather than selective, and its cost is borne primarily by the host country levying the low tax. Indeed, the type of investment which it attracts to LDCs has little to do with the desirability of the investment for development, but rather the arbitrary (from a developmental standpoint) existence of excess tax credits and/or investment in high-tax countries for individual firms. Hence it is clearly inferior to the alternative tax incentives for development which will be discussed below.

The U.S. commitment to capital export neutrality, as embodied in the foreign tax credit, is widely accepted (though the AFL-CIO did seek to replace the credit with a simple deduction via the Burke-Hartke bill). More policy attention has been directed to the deferral provisions, under which the United States levies no tax on foreign earnings until they are repatriated to the United States.

The principle of "capital import neturality," or "competitive neutrality," holds that the U.S. investor's tax burden within the

confines of any particular national jurisdiction should be equal to the tax burden of other firms in that jurisdiction as long as the income of the U.S. investor remains there. The goal is to ensure that U.S. firms are competitive with both host country firms and third country multinational enterprises (since all other home countries defer, or have equivalent provisions).

Deferral provides an interest free loan to the investing firm, the amount of which is equal to the deferred tax (see Table 16). Hence it represents a general inducement to foreign versus domestic investment for firms based in the United States (and other home countries, all of which have equivalent tax provisions). It is particularly potent in stimulating foreign reinvestment of the earnings of U.S.-based multinationals, as opposed to repatriation (which leads to an increased tax liability) and possible deployment of the funds in the United States.

The most profound impact of deferral in stimulating the flow of direct investment to the LDCs, however, is probably its key role in validating their own tax incentives. The most generous tax holidays offered by host countries would be worthless to a U.S. firm if the United States taxed foreign income currently, since there would then be no net tax incentive for the firm. Practically all developing countries (and many developed countries) have some tax incentives designed to attract the foreign investor. Indeed, "incentive races" have existed for many years as host countries compete with each other

Table 16

DEFERRAL VERSUS NO DEFERRAL

	Deferral	Current U.S. taxation of foreign income
Subsidiary income	10,000	10,000
Foreign tax rate	40%	40%
Foreign taxes paid	4,000	4,000
U.S. tax due[a]	0	5,000 [50% x 10,000]
Foreign tax credit	-	4,000
U.S. tax paid	0	1,000
Total taxes	4,000	5,000
Effective tax rate	40%	50%

a Assumes no repatriation of profits to United States.

to attract foreign direct investment. To the extent that developing countries are willing to extend such incentives, deferral de facto tilts U.S. foreign direct investment in their direction.[60]

There are two issues which must be considered concerning the development aspects of these tax incentives: their effectiveness in attracting foreign direct investment, and their impact on government revenues. Most host countries appear to accept the view that a sacrifice in tax revenues in the present is more than offset by the gain in revenues (and other benefits) resulting from the increase in income which results in the future as a result of increased investment.[61] Indeed, representatives of such countries have actively supported U.S. multinationals in their efforts to avoid losing the deferral provisions through Congressional action.

However, the evidence on the subject is contradictory. The revenue effects of foreign direct investment may remain quite low for countries which extend generous tax treatment to investment. Many case studies indicate that tax incentives play a minor role in the investment decision, with strategic factors dominant. Indeed, Aharoni concluded that tax incentives play almost no role,[62] which suggests that host countries are needlessly sacrificing revenue. On the other hand, two studies of regional development tax incentives in European countries clearly indicate that such measures are important in determining

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60 In addition, the U.S. "last-in-first-out" technique of administering the deferral provisions ensures that there will be no U.S. tax on tax-incentive income even if such earnings are distributed after the host-country tax relief has ended. Department of the Treasury, op.cit., pp. 33-34.

61 As noted by Bos (see p. 16).

62 Yair Aharoni, The Foreign Investment Decision Process (Division of Research, Graduate School of Business Administration, Harvard University, 1966).

which foreign country will attract a given plant.[63]

Even if tax incentives play little or no role in the initial selection of a foreign investment project, it is important to note their impact on reinvested earnings. It is more likely that the decision to undertake a new project in a strange environment would be dominated by other variables, but that the expansion of the investment could be more affected by policy -- especially a tax policy which provides a major premium for keeping funds abroad rather than repatriating them.[64] Unfortunately, there has been no research comparing investments taken under the auspices of incentives with what would have been invested in the absence of the tax incentives. This comparison with "what would have happened otherwise," as we saw in assessing the impact of foreign direct investment on development, is the only correct measure of the effectiveness of the sacrifice in revenue which is a result of the tax incentives. Given the proliferation of these incentive programs, it is surprising that no empirical estimates of their effectiveness exist. This is an ideal area for future research.

The extent to which deferral has stimulated the flow of direct

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63 G. N. Yannapoulous and J. H. Dunning, "Multinational Enterprises and Regional Development: An Exploratory Paper," University of Reading Discussion Paper No. 21, April 1975, and Bernard Snoy, Taxes on Direct Investment in the EEC, A Legal and Economic Analysis (New York: Praeger, 1975), esp. Chapter 27.

64 The analysis in Chapter 3 of American Multinationals and American Interests, on the impact of foreign direct investment on U.S. trade and jobs, suggests that the foreign subsidiaries do in fact increasingly take on a life of their own independent of the parent firm. Tax provisions such as deferral encourage such an evolution.

investment to the LDCs is subject to a good deal of debate. Using the Brookings model, with an assumption that the firm can choose debt as a mechanism to finance the subsidiary in the absence of deferral and that the geographic distribution of foreign direct investment would not change in response, the annual flow of foreign direct investment in manufacturing industries in the LDCs would fall by about 8.5 percent, or $300 million at the 1974 level.[65]

The effects of deferral on foreign direct investment in the developing countries are quite similar, in qualitative terms, to the effects of the overall option for calculating the foreign tax credit. Both support tax incentives offered by host countries. Both encourage transfer pricing into such countries -- out of the United States, in the case of deferral. U.S. elimination of deferral, without substituting something better, would clearly be regarded as a hostile act by the LDC.

However, deferral (like the overall option) is wholly non-selective in the types of investment it supports. The costs are borne primarily by the host countries, who may be sacrificing significant revenue for a highly uncertain return. From a development standpoint, deferral has the virtue of existing -- but an entrenched part of that existence is its applicability to developed as well as developing countries. Deferral

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65 Industry sources and other outside observers have derived higher figures. An immediate cutback of only 2 percent in the growth of the foreign subsidiaries of U.S. multinationals is derived by Robert Stobaugh, The U.S. Economy and the Deferral of U.S. Income Tax on Foreign Earnings (Cambridge, Mass.: Management Analysis Center, 1975), p. 5-10. He goes on to argue, however, that the cutback would be greater in subsequent years because of a resulting decline in their competitive positions vis-a-vis firms of other countries which continued to defer.

too is inferior, from a development standpoint, to the alternatives to be discussed.

Another important aspect of the U.S. tax code with respect to foreign direct investment is the non-eligibility of such investment for coverage under the investment tax credit (ITC).[65a] The ITC violates the principle of capital export neutrality by applying only to plant and equipment expenditures made in the United States. Our model indicates that extension of an ITC at the traditional rate of 7 percent (as opposed to the current rate of 10 percent) to the entire foreign sector would increase the annual flow of U.S. investment in the manufacturing sector in the developing countries by 12.6 percent, or over $400 million at the 1974 level, on the assumption that the shares of foreign direct investment in developed and developing countries did not change as a result.[66]

The non-applicability of the ITC to foreign investment partly offsets the support provided for foreign direct investment by deferral and the foreign tax credit. It more than offsets the effects of deferral alone, though by a very small amount (about 3 percent, or $100 million at the 1974 level of manufacturing investment in LDCs). At the current rate of 10 percent, it probably would about offset the effects of deferral plus the overall option for calculating the foreign tax credit.

65a And the Asset Depreciation Ranges (ADR), under which domestic investment is eligible for faster depreciation writeoffs than is foreign investment.

66 In trying to persuade Congress to extend the ITC (at 7 percent) to selected LDCs in 1967 (see below, p. 86), Treasury estimated that the revenue cost of doing so for Latin America would be "under $15 million." Our estimate of the revenue effect in 1974 is about $80 million, a somewhat higher figure since total U.S. manufacturing investment in LDCs in 1974 was only about three times as great as U.S. manufacturing investment in Latin America in 1967.

Finally, the favorable tax treatment provided since 1971 for Domestic International Sales Corporations (DISCs) probably has an important adverse effect on foreign direct investment in the developing countries. DISC subsidizes U.S. exports by effectively reducing U.S. taxation of the export earnings of firms located in the United States by about 25 percent. As a result, the return to U.S. firms from DISC-assisted export sales is more than two-and-a-half times as large as their returns from domestic sales.

Our models do not permit us to estimate the resultant effect on investment abroad by U.S.-based firms. However, to the extent that it has any real impact on investment decisions, DISC must particularly deter those investments motivated by a desire to penetrate world markets. An important, and perhaps increasing, share of manufacturing investment in the developing countries by multinational enterprises has that objective. Hence DISC, and all other such export incentives in home countries of multinational enterprises, discourage a type of foreign

direct investment in the poorer countries which is usually desirable from a developmental perspective.

With the advent of flexible exchange rates, any original rationale for DISC has largely disappeared.[67] Indeed, it has been under steady attack almost from its inception, and its provisions were tightened in both 1975 and 1976. Developmental objectives should be added to that attack.

Tax Provisions which Apply Specifically to Developing Countries

Within the present U.S. tax code, there are three provisions which relate specifically to investments located in areas designated by executive order as less developed regions: the exemption from grossing up, the exemption from Section 1248, and the geographical exclusions including Western Hemisphere Trade Corporations.[68]

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67 Any net increase in U.S. exports generated by DISC produces an appreciation of the dollar. This in turn discourages other exports as well as increasing imports, etc. The DISC thus cannot have much net impact on the balance of payments, and its chief implications are distributional.

68 In addition, as part of the trend toward generally tightened tax treatment of all foreign income earned by U.S. corporations, two provisions which previously provided preferred treatment for "less developed country corporations" were eliminated by the Tax Reduction Act of 1975. One exempted such corporations from the elimination of deferral already voted for tax-haven investments in the Revenue Act of 1962; income earned by tax-haven subsidiaries from "LDC corporations" continued to be deferred. The other gave preferred status to income from "LDC corporations" in calculating the effective tax rate and percentage of earnings distributed to shareholders, some combinations of which also enabled tax-haven subsidiaries to retain deferral; the entire exception for "minimum distributions" was eliminated in 1975, taking the preference for LDCs with it. The effect of both provisions on development was undoubtedly small, resting as it did on unique combinations of host and home country tax rates and particular corporate practices.

The exemption from "grossing up" increases the rate of return on an investment in a developing country as compared with an investment in a developed country. Table 17 shows that, assuming a 100 percent rate of repatriation and a foreign tax rate of 25 percent, the exemption from grossing up results in an effective tax rate which is 6.25 percentage points less than the effective tax rate in the presence of grossing up. Further gains can be achieved if the parent utilizes the "sub-subsidiary method," in which income from one affiliate is first paid in dividends to an LDC corporation which in turn pays the dividend to the parent. The maximum tax benefit for the firm is obtained when the foreign tax rate is exactly one-half the U.S. tax rate.

It is difficult to judge the effect of this provision with regard to investment in the LDCs. Numerical exercises utilizing the historical rate of repatriation (approximately 40 percent) and the optimum foreign tax rate (24 percent) yield a difference in the effective tax rate of only 2.3 percent. The size of the incentive increases as more income is repatriated. This means, however, that it may have a perverse impact on development by generating an incentive to repatriate rather than to reinvest earnings. (Thus it operates in a contrary direction to the reinvestment incentive provided by deferral). In addition, the incentive becomes a penalty if the host-country tax rate exceeds the U.S. rate (48 percent). The fact that income from a source other than an LDC corporation itself can be channeled through such a corporation, thereby receiving the benefit of the provision, also makes it subject

Table 17

THE EFFECTS OF "GROSSING UP"

	Exemption from grossing up	Grossing up
Subsidiary income	10,000	10,000
Foreign tax rate	25%	25%
Foreign tax	2,500	2,500
Earnings after tax	7,500	7,500
Dividend to parent	7,500	7,500
U.S. tax rate	50%	50%
Pre-credit U.S. tax	3,750 (.50 x 7,500)	5,000 (.50 x 10,000)
Foreign tax credit $2,500 \times \frac{7,500}{10,000}$	1,875	2,500
Net U.S. tax	1,875	2,500
Net return after all taxes	5,625	5,000
Effective tax rate	43.75%	50%

to the charge that it is merely another device which firms can utilize for tax avoidance purposes.

To see how big or small the effect may be, Table 18 shows for eight developing countries the U.S. tax liability with and without the exemption from "grossing up." The figures in the first four columns of Table 18 indicate the current situation. The figures in the fifth through the eighth columns show the U.S. tax situation if "grossing up" were required. Finally, the ninth column shows the potential increase in the U.S. tax liability per $1000 in pre-tax income.[69]

The ninth column shows that the potential increase in U.S. taxes ranges from a high of 4.3 percent ($43 per $1000) for income from the Philippines to a low of 1.1 percent for income from Mexico.[70] Since we have data for only a few developing countries, and since both investment patterns and foreign tax rates have shifted since 1968, we can make only a "best guess" that requiring "grossing up" might increase the tax burden on income from those countries by 3-4 percent. Thus the exemption from "grossing up" is a very small incentive to foreign direct investment in the poorer countries. As noted, it also encourages repatriation rather than reinvestment of earnings. And it places the real subsidy

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69 This increase is potential only, for higher taxes would be paid only if the American investor lacked excess tax credits from high-tax host countries (assuming continuation of the overall option for calculating the foreign tax credit). Investors with sufficient overall tax credits would still avoid paying any additional U.S. taxes. Under the current system, the typical American manufacturing multinational has a small surplus of foreign tax credits which would be eliminated, but not reversed, by requiring grossing-up.

70 The maximum potential increase in U.S. taxes would be $58 per $1000 pre-tax income, which would result from a foreign income tax of 24 percent and a dividend payout ratio of 100 percent.

Table 18

IMPACT OF ELIMINATING EXEMPTION FROM "GROSSING UP" FOR EIGHT DEVELOPING COUNTRIES, ASSUMING 1968 TAX AND DIVIDEND RATES

(Per thousand dollars of pre-tax earnings)

	With exemption from grossing up				Without exemption from grossing up				
Country	Tentative U.S. tax Liability	Foreign tax credit	Deficit in U.S. credit	Global tax burden	Tentative U.S. tax Liability	Foreign tax credit	Deficit in U.S. credit	Global tax burden	Increase in U.S. tax burden
Mexico	131	170	-39	438	227	255	-27	449	11
Panama	365	182	183	398	424	199	225	440	42
Argentina	227	160	68	342	291	188	102	376	34
Brazil	216	248	-32	381	309	306	3	416	35
Chile	138	210	-72	373	206	256	-51	394	21
Peru	261	337	-77	407	384	420	-36	448	41
Venezuela	106	99	7	340	151	127	24	357	17
Phillipines	297	400	-103	410	422	477	-55	453	43

burden on the host country, by relating directly to its tax rate. Indeed, it penalizes any host country rate above 24 percent. Hence this particular tax provision is not a very appealing incentive, and indeed is being phased out under legislation passed in 1976.

The second incentive designed explicitly for income derived from investments in LDCs is the exclusion from Section 1248. The exclusion requires assets liquidated in an LDC to be treated as capital gains rather than ordinary income, and thus to be taxed at the lower rate applicable for capital gains. If the foreign tax rate exceeds 23 percent, however, the firm would minimize its tax burden by using the foreign tax credit instead -- but it cannot do so, because this provision is mandatory. Hence firms contemplating liquidation in LDCs either repatriate earnings prematurely, to take advantage of the credit, or press the host country to keep its tax rates extremely low. Neither outcome promotes development goals. Even in countries where the exclusion would help a firm, it must retain majority ownership of the equity for ten years to qualify. Hence the provision also works against gradual divestiture, which is sought by some host countries, and in some cases may add to the contribution of a project to development.[70a]

The final provisions specifically designed for income derived from less developed areas are those covering geographic corporations -- the Western Hemisphere Trade Corporations, China Trade Act Corporations, and the possessions corporations. The China Trade Act Corporations were added to the U.S. tax code in 1922 and were aimed at promoting U.S. trade with China. A China Trade Act Corporation is totally exempt from U.S.

70a As argued by Hirschman, How to Divest in Latin America and Why.

taxes if its income is totally generated in Hong Kong or China (now Taiwan). In the event that some of its income is not derived solely from China, it still is exempt if it distributes dividends equal to the amount of tax due in the absence of the exemption. This incentive may have played a role in the location of U.S. investment in Taiwan, but only a few such corporations exist and there are no empirical estimates of their effects.

Western Hemisphere Trade Corporations were authorized in 1942. A firm can choose to be considered a WHTC if all of its business is carried out in the Western Hemisphere, 95 pe.cent of its income is foreign-source, and 90 percent of its income is from trade or business. The WHTC provides a sizable incentive, but is of little use in manufacturing because the subsidiary is a superior form of organization for tax purposes. The U.S. Treasury estimates that eliminating it would bring in only $20 million in additional revenue annually.

In addition, only a small portion of that revenue would seen to promote manufacturing investment in Latin America. Exporters can benefit from the provision. Investments in Canada, which is hardly underdeveloped, are eligible. The WHTC was quite useful in the extractive industries, since it could be used along with the depletion allowance, until that allowance was eliminated in 1975. So its developmental impact is dubious.

Expropriation Losses

A final facet of the tax code which mainly affects investment in less developed countries is the treatment of losses due to expropriation.

While the number of expropriations has been substantial over the years, just compensation to the previous owner has been granted in the overwhelming majority of the cases. Nevertheless, the small minority of cases in which the final outcome was uncompensated expropriation represented a total loss of $6 billion to all home countries from 1956 through 1972.[71]

While the general treatment of "capital" losses is quite complicated, due to complex insolvency provisions, the procedure for wholly owned subsidiaries is straightforward. If the parent owns 95 percent of the subsidiary, and the subsidiary derived 90 percent of its income from the active conduct of business, then the capital loss due to expropriation may be deducted from the ordinary income of the parent. If the loss exceeds the income of the parent, the deduction may be carried forward for ten years. Only the value of the equity held by the parent can be deducted, however. This clearly understates the value of the subsidiary to the parent, due to the fact that neither capital gains nor other mechanisms of financing the subsidiary can be deducted. Hence this provision, like those just discussed, does not provide much real support for foreign direct investment in the developing countries either.

Summary

The effects of the U.S. tax system in supporting investments which promote development in the poorer countries are highly questionable.[72]

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71 M. L. Williams, "The Extent and Significance of the Nationalization of Foreign-Owned Assets in Developing Countries, 1956-1972," Oxford Economic Papers, Vol. 27, No. 7 (July 1975), p. 271.

72 In American Multinationals and American Interests, we also find several problems from the standpoint of more direct U.S. interests. See especially Chapters 5, 6 and 13.

The exemption from "grossing up" and the exclusion from Section 1248 encourage repatriation of earnings, and hence can have negative effects on development. WHTCs are of more use to exporters and shipping companies than to direct investors in LDCs. The investment tax credit discriminates against foreign direct investment.

Even the three major features of the U.S. tax system which generally promote foreign direct investment -- the foreign tax credit, the overall option for calculating it, and deferral -- treat all investments alike, regardless of the country or industry or their contribution to development. In view of the evidence concerning the rather sizable variations in developmental effects among different investments, as outlined in the first section of this paper, such generalized support is questionable development policy. Nevertheless, any changes in these pro-investment provisions would be regarded as hostile acts by developing countries unless offsetting measures were adopted simultaneously.

Alternative Approaches

There are three sensible methods which could be used to provide tax incentives to foreign direct investment in developing countries: extension to such investment of the investment tax credit, a special tax credit for LDCs modeled on the "Boggs bill" of 1964, and tax sparing. Any of the three could be set to meet the criteria prescribed at the outset of this discussion: significant magnitude, temporariness, selectivity in several senses, and the bearing of cost by the home

country. Each of the approaches could be applied across-the-board, or to a selected list of countries and/or industries, or much more specifically through the medium of tax treaties.

One approach is to extend the investment tax credit (ITC), which now applies only to investment in the United States, to investment in developing countries. Among the various tax incentives to investment, the ITC is viewed by most experts as most likely to generate additional spending on plant and equipment.[73] It operates directly on new investment spending, unlike the overall corporate tax rate or even depreciation allowances.

There are several ways in which the ITC could be extended to promote foreign direct investment in developing countries. To eliminate its current discrimination against all foreign investment, it could simply be extended to the entire foreign sector. In doing so, the rate of credit could be set at a higher level for the developing world. Or, to get even greater selectivity, three rates could be set: a rate equal to the U.S. rate for the industrialized countries, a somewhat higher rate for the Third World, and a significantly higher rate for the Fourth World.

It must be recognized, however, that domestic politics in the United States make it extremely doubtful that the ITC could be extended to all foreign direct investment. In addition to the general opposition

73 See several of the essays in Gary Fromm, ed., Tax Incentives and Capital Spending (Washington: Brookings Institution, 1971).

of organized labor and some others to all foreign direct investment, and any policies which promote it, the ITC was originally sold partly on the grounds that it would (a) offset the allegedly more liberal tax treatment of corporations in other industrialized countries and (b) help the U.S. balance of payments by improving the competitiveness of U.S. firms. The advent of flexible exchange rates should mute the latter concern to some extent, but globalization of the ITC in the interests of capital export neutrality seems decidedly unlikely.

From the developmental standpoint, a more realistic effort is thus to seek extension of the ITC solely to developing countries, or even to the Fourth World alone. The rate could be set equal to the U.S. rate, higher or even lower. In any case, all other things equal, the effect would be a greater incentive to invest in the poorer countries than now exists.

The Kennedy and Johnson Administrations supported an extension of the ITC to selected LDCs by applying the then-existing U.S. rate of 7 percent, against U.S. income of the investing firm, to new capital contributed to the foreign concern and to retained earnings beyond the "normal" 50 percent.[74] They did in fact negotiate tax treaties which would have done so in three cases (Thailand, Israel, and Brazil) and

74 Some of the developing countries with which the ITC was negotiated asked for 10 percent, which has since become the ITC rate, but the United States refused. Nevertheless, these countries reportedly concluded that the resultant benefits, even at 7 percent, were roughly the equivalent of sparing and hence accepted the approach though they had previously preferred sparing (see below).

would have extended the approach across a wide range of developing countries had Congress ratified these prototypes.[75] However, the Senate Foreign Relations Committee rejected the whole approach on the grounds that (a) the objective of the ITC was to help the U.S. balance of payments by discriminating against foreign direct investment and (b) the impact of foreign direct investment on development was uncertain.

An alternative approach, tailored specifically to foreign direct investment in the LDCs, was contained in House Resolution 11524 of 1964 (the "Boggs bill"). It provided a substantial (30 percent) credit for investment in the LDCs above the historical average for each firm, for a temporary period of five years. It would not have allowed a credit for investment financed by host country savings, but only for capital brought in from abroad. Any firm found abusing the provision was subject to sizable penalties. Hence the approach was tied directly to the act of investing in the LDCs, and minimized the potential for windfall gains. The bill was supported by the Johnson Administration, but made no progress in the Congress.

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75 See Tax Convention with Thailand, Hearings Before the Subcommittee on Foreign Relations, U.S. Senate, Aug. 11-25, 1965, esp. pp. 31-2 and 43-4, and Tax Conventions with Brazil, Canada, and Trinidad and Tobago, Hearings Before the Committee on Foreign Relations, U.S. Senate, Oct. 5, 1967, esp. pp. 104-6. The detailed analyses of the treaties indicate that the proposed extension of the ITC would have been more liberal in some features, and less liberal in others, than the domestic ITC. Its continuation would have been re-examined after five years, providing a measure of temporariness, and (in the later Brazil treaty) would have lapsed or been modified pari passu with any changes in the domestic ITC. In presenting the Administration's proposal, Treasury Assistant Secretary Stanley S. Surrey advocated it "as the elimination of the disincentive to investment in the treaty country" which resulted from applying the ITC only to investment in the United States (p. 7). This approach was also favored by the OECD Fiscal Committee in its 1965 report, Fiscal Incentives for Private Investment in Developing Countries.

Like a simple overseas extension of the investment tax credit, the Boggs bill incentives would operate independent of host-country tax (and other) policies. Their costs would be borne primarily by the United States rather than the host country. The firm would receive a credit against its U.S. taxes as a result of its foreign investment, without reference to the level of foreign taxation. The only important problem with this approach, from a development standpoint, was its inadequate selectivity: it provided support for investment in all sectors,[76] and made no effort to differentiate among the various members of the Third and Fourth Worlds.[77]

The United States could use tax treaties to apply either the ITC or Boggs approaches. Through such treaties, individual host countries could have substantial input in the design of the incentives. The incentives could be tailored to fit their institutional structure and development needs. This would promote a great deal more selectivity, in all three senses mentioned above: the United States could limit such treaties to the poorer countries, and to poorer regions in more developed countries, and the incentives could be

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76 During the debates over extending the ITC to foreign direct investment, Senatorial concerns of a different type than addressed above arose over industry selectivity: they most opposed such a credit to LDC industries which competed directly in the U.S. market, particularly with industries in their own states (most notably textiles). In an effort to counter this type of domestic political problem, the Johnson Administration proposal for extending the ITC to Brazil would have applied only to the extent that eligible investments in Brazil were carried out with equipment produced in the United States.

77 This shortcoming was understandable. In 1964, the differences between the Third and Fourth Worlds were not nearly as striking as is now the case.

limited to industries and even production techniques which seemed promising in promoting precise development objectives.

Through tax treaties, the United States could also offer tax sparing -- exemption from U.S. taxation of any cash flow to multinational enterprises generated by host-country incentives. Sparing would be more generous than current policy, which only defers (albeit, in practice, frequently for very long periods of time) rather than forgives U.S. taxation of such cash flows. This approach has been favored by various UN groups, and is employed by several other home countries (Germany, U.K., Sweden, Japan, France, Denmark, Norway and Finland) at present.

However, it is inferior to the ITC and Boggs approaches for two reasons. It relies on the general liquidity impact of the incentive to generate additional investment, rather than tying the incentive directly to investment spending. And the burden of the subsidy falls primarily on the host country, as under the current deferral approach.

The Eisenhower Administration supported sparing and the Treasury Department negotiated sparing agreements with India, Pakistan, Israel and the United Arab Republic in the late 1950s. But the Senate refused to ratify the sparing provision of the Pakistan treaty, and the Johnson Administration withdrew the others in 1964 after they had lain dormant until that time. Opposition was based largely on the principle that sparing, by reducing U.S. taxes on U.S. corporations for taxes <u>not</u> paid to other countries, would treat foreign investment better than investment in the United States and would also let those countries

effectively determine an increasing share of the U.S. tax rate.[78]

Even from a development standpoint, however, doubts were raised which related to the existence of deferral. In the presence of deferral, which provides an incentive for reinvestment abroad of foreign earnings, sparing may discourage such reinvestment because it permits similarly favorable tax treatment in the United States even when earnings are repatriated. Hence it can run counter to developmental objectives. If deferral were eliminated, sparing would become a more attractive option from a development perspective.

In order to avoid windfall gains to the firms, tax sparing must be carried out on a country-by-country basis. Thus, even more than the ITC or Boggs approaches, the incentive can be designed to fit the particular needs of each host country and is best applied through tax treaties. For example, the sparing agreement negotiated between the United States and Pakistan (but never ratified by Congress) incorporated an incentive which varied inversely with the rate of return earned by the project.[79] It also met the criterion of temporariness by sparing only temporary Pakistani incentives rather than the several permanent exemptions from local taxes offered to investors there. The other types of selectivity mentioned above could also easily be built into the treaties.

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78 This argument is elaborated in Stanley S. Surrey, "The Pakistan Tax Treaty and 'Tax Sparing'," National Tax Journal, Vol. 11 (1958), pp. 156-67.

79 Joseph P. Crockett, "'Tax Sparing': A Legend Finally Reaches Print," National Tax Journal, Vol. 11 (1958), pp. 146-55.

Trade Policy

With the mounting evidence that import substitution strategies of industrialization leave much to be desired, attention has focused increasingly on the role of exports. Economies of scale are necessary to foster efficient manufacturing industries, and few developing countries (or even regions) have internal markets of adequate size for this purpose. The success of this approach depends crucially on the commercial policies (as well as economic growth) of the developed countries, which alone are capable of absorbing a sizable volume of products from the developing countries. In addition to supporting the expansion of local host-country industry, home-country trade policies thus are an important factor in promoting certain types of foreign direct investment in developing countries.

The single most important market for the manufactured exports of LDCs is the United States, which now imports over $10 billion of such products. In addition to its direct effects on LDC exports, U.S. trade policy has an important bearing via its impact on the willingness of other industrialized countries to provide LDCs with access to their markets. The United States remains the single most important country in determining whether world trade policy evolves in liberal or protectionist directions. Hence U.S. policy has a multiplier effect in terms of market access for LDCs.

Some LDC manufactured exports to the United States are limited by U.S. import barriers. However, these barriers exist primarily in

industries which are not characterized by much U.S. foreign direct investment, such as textiles. In most industries, a U.S. policy of facilitating the export of manufactures from LDCs can help their development via promoting foreign direct investment as well as supporting the expansion of purely local industries.

From 1965 through 1973, LDC exports of manufactured goods rose by a spectacular annual average of 25 percent. The tariff liberalization of the Kennedy Round undoubtedly helped, but this performance suggests that they will do well if there is no backsliding toward new import controls in the industrialized world.[80] It is thus crucial that the United States avoid backsliding itself, and seek vigorously to discourage other countries from doing so.

Still better, from the development perspective, is further liberalization. Within the context of global trade liberalization, there are several options for providing particular benefits for poorer countries. Bigger cuts in tariffs and non-tariff barriers can be made on products of special interest to them, as per the recent U.S. negotiating offer in the Multilateral Trade Negotiations in the GATT. In addition, cuts negotiated on such products could be implemented immediately, rather than staged over the usual number of years.

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80 And no prolonged world recession. Their export growth was slower in 1974, and may have declined in absolute terms in 1975. For a recent compilation of data see IBRD, "Recent Trends in Manufactured Exports From Developing Countries," March 15, 1976.

The most important U.S. trade policy which aims solely at the LDCs is the generalized system of tariff preferences (GSP), finally implemented in January 1976 after twelve years of discussion. The GSP provides duty-free treatment for over 4,000 manufactured and semi-manufactured products from virtually all developing countries (excluding the members of OPEC and one or two countries with unsettled disputes with the United States over compensation for expropriated investments). In addition to its direct trade effect, GSP should in principle encourage additional foreign direct investment of the "export platform" variety in eligible countries. Indeed, some proponents of the scheme have viewed this as one of its major advantages.

However, the U.S. scheme -- like the European and Japanese schemes, which were implemented several years ago -- is extremely restrictive. Once U.S. imports of a particular product from a particular LDC reach $25 million, or 50 percent of all U.S. imports (no matter how small the ratio of imports to total U.S. consumption of the product), the preference is rescinded. This so-called "competitive need" test, while defensible in principle, is set so low that little foreign direct investment is likely to flow in response to the new incentive. In addition, a number of "sensitive" products are excluded from the scheme altogether.

Hence liberalization of the GSP, by both the United States and other industrialized countries, would help promote desirable types of foreign direct investment in the poorer countries. The product coverage could be extended. The ceilings could be raised, or even abolished.

If these improvements could not be extended to all developing countries, perhaps they could be used to provide extra preferential treatment for the Fourth World. Export-oriented foreign direct investment would be encouraged by such changes.

The second U.S. trade policy which is directly relevant to direct investment in LDCs is Sections 806 and 807 of the Tariff Code. These provisions limit the application of U.S. tariffs to the portion of imported commodities whose value was added abroad, exempting from duty any U.S. components in them. They are now used intensively by a growing number of industries (following toys and electronics) in Mexico and the Far East. Multinational enterprises have made extensive use of the provisions to take advantage of low cost labor, by exporting certain facets of the production process which are highly labor intensive. U.S. imports under Sections 806 and 807 grew from $953 million in 1966 to $5.2 billion in 1975, of which $3.9 billion was value added abroad.

While Sections 806-807 have been of great use to the firms, the benefits accruing to the host countries are less clear. On the one hand, the exports generated by the investments provide a major source of foreign exchange. Countries which have hosted such investment (Mexico, Korea, Taiwan) have attained high growth rates. Elimination of the two provisions would have reduced foreign value-added embodied in U.S. imports (from both developed and developing countries) by an estimated $2.7 billion in 1972.[80a] On the other hand, as discussed in the first section of this paper, these "export platform" industries may not do better than domestic firms in the same industry -- and Sections 806-807 discriminate <u>de facto</u> in favor of U.S.-based multinationals,

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80a J. M. Finger, "Trade and Domestic Effects of the Offshore Assembly Provision in the U.S. Tariff," <u>American Economic Review</u>, Sept. 1976, p. 607. Finger estimates that Sections 806-807 are worth as much to the LDCs as the EEC system of generalized tariff preferences (p. 609).

which are more likely to use U.S. components, over local firms (and third-country multinationals). Nevertheless, elimination of Sections 806 and 807 would discourage a type of foreign direct investment which can be helpful to the development process in many poorer countries, especially those in the Fourth World which may have trouble breaking into world markets without outside help.

Risk Insurance

One of the major impediments to the flow of foreign direct investment to the LDCs is their greater risk. The political instability in many LDCs, coupled with the general problems of operating in a strange environment, dissuade many firms from undertaking projects which would be actively considered under normal conditions. As indicated above, in the section dealing with the tax treatment of losses, fears of expropriation also remain a sizable deterrent to such investment.

In order to reduce such risk, the U.S. Government provides insurance for U.S. investors against losses due to wars and civil disorders, expropriation and currency inconvertibility. The program focused initially on Western Europe, and shifted to today's LDCs in the late 1950s. In 1969, the program moved from AID to the newly created Overseas Private Investment Corporation (OPIC). The case-by-case approach of the insurance program makes it the only U.S. policy now capable of readily adopting the selective approach advocated throughout this paper, and hence makes OPIC a promising tool for promoting the developmental contribution of foreign direct investment.

In recent years, the program appears to have become less effective from a developmental perspective, however. OPIC was formed during a period of growing overvaluation of the dollar, increased import penetration in several industries and concomitant pressure for restrictions against both imports and foreign direct investment, major concern with the chronic U.S. balance-of-payments deficit, and declining interest in assisting the less developed countries. Thus, although OPIC was to help only those projects which would have a favorable impact on the development of the host country, it came under increasing pressure not to insure projects which would have detrimental effects on U.S. jobs or the U.S. balance of payments. As the AFL-CIO mounted its attack on foreign direct investment as a major "exporter of U.S. jobs" in the early 1970s, domestic employment effects became a particularly important concern of OPIC.

OPIC estimates, for example, that the twenty-five new projects which it insured during the first quarter of 1976 will benefit the U.S. balance of payments by almost $1 billion during the succeeding five years. At the same time, the balance-of-payments positions of the host countries are estimated to benefit by about $1.6 billion during the same period.[81] Such an outcome is theoretically possible, with matching balance-of-payments losses to third-country trade and capital accounts.[81a] But the emphasis on U.S. economic benefits has inevitably reduced the focus of the program on development.

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81 OPIC, "U.S. Benefits and LDC Developmental Effects of Projects Insured by OPIC During the Third Three Month Period of FY 1976," April 27, 1976.

81a This may be offset, however, by the effects on the United States of the investment insurance programs of other home countries. The U.S. program is probably at least as development-oriented as those of the "OPICs" which exist in sixteen other home countries, and is probably more so than most of them.

A second major problem with OPIC, particularly after Congress in 1974 mandated the steady "privatization" of many of its functions, arises from the directive that -- as a corporation rather than a government agency -- it is to follow standard risk management practices with the eventual goal of financial self-sufficiency. In inheriting a portfolio created by AID, which was motivated more by development concerns than risk minimization, OPIC thus sought to insure many less risky projects, in less risky (and hence usually less undeveloped) countries. It was increasingly motivated by the requirements of financial self-sufficiency and the need to "balance its portfolio."

Comparable data on OPIC country coverage are available only for the past few years. From the beginning of 1971 through November 1973, the share of the Fourth World in the OPIC portfolio rose from 33 percent to above 48 percent. Between November 1973 and February 1976, however, the Fourth World share has declined: from 43 percent to 27 percent for inconvertibility risks, from 48.5 percent to 44.6 percent for expropriation risks, and from 50.6 percent to 45 percent for war risks (Table 19).[82]

On the other hand, the OPIC finance program has shifted toward the poorer countries. In fiscal 1973, all but one of its nine projects went

82 Foreign Affairs Division, Congressional Research Service, The Overseas Private Investment Corporation: A Critical Analysis, Sept. 1973, pp. 64-6, concludes that 93 percent of OPIC's coverage from its inception through mid-1973 was in 13 countries, of which only three (Botswana, India and Zaire) and about 20 percent of the total coverage were in the Fourth World. The CRS concluded (p. 39) that OPIC "has not been guided to the same extent [as its predecessor program under AID] by social and economic development considerations," and (p. 109) that "evidence is lacking that OPIC is likely to stress its economic development mandate any more vigorously than it has during the last 2 1/2 years." Congressional pressure, however, has been a major factor in determining that evolution.

Table 19

COMPOSITION OF OPIC INSURANCE COVERAGE:[a]

1971 - FEBRUARY 1976

(In percent)

	Third World[b]	Fourth World[c]
Total program:		
January 1971	67.0	33.0
November 1973	51.6	48.4
February 1976	58.4	41.6
Inconvertibility:		
November 1973	56.9	43.1
February 1976	73.0	27.0
Expropriation:		
November 1973	51.5	48.5
February 1976	55.4	44.6
War risk:		
November 1973	49.4	50.6
February 1976	55.1	44.9

Source: OPIC

a/ "Current" as opposed to "contingent" or "maximum" coverage. Data supplied by OPIC.

b/ All of South America except Bolivia and Paraguay, all of East Asia, all of Europe (mainly Yugoslavia, Portugal, Greece and Turkey), Iran and Israel.

c/ All other developing countries, i.e., all of Africa, South Asia, Central America and the Caribbean.

into OPEC countries, Brazil, or Taiwan. But in fiscal 1974 and 1975, only one of six and one of twelve projects, respectively, were in the more developed countries of the Third World. The finance program is much smaller than the insurance program, however, and these changes represent only a mild offset to the general trend toward a reduced focus on the poorest countries.

OPIC has basically gone the route of most U.S. foreign aid programs. Lacking a unified constituency, its evolution mirrors the conflicting and ever-shifting premises which underlie its activities. These conflicting premises in turn mirror the ebb and flow of the U.S. commitment to aid, and of internal U.S. economic concerns (such as jobs and the balance of payments). The program is expected to serve too many masters. In this case, the policy seeks to meet the short-term economic needs of both the home and host country -- frequently an impossible task. As a result, when evaluated from a developmental perspective, it must be judged substantially less effective than it could be. As long as OPIC focuses so heavily on its economic effects in the United States as well as in the recipient countries, and insures so many projects in countries least in need of home-country assistance in attracting foreign direct investment, the decision to privatize OPIC seems wise since it no longer serves a basically developmental function.

There is a superior alternative, however, to utilize OPIC's exceptional potential and proven expertise. The organization should henceforth insure investments only in the Fourth World, primarily the

thirty or so poorest countries in South Asia and Africa, where risk remains high and home-country support is still needed to attract foreign investors. Its finance (as opposed to insurance) program might well be extended, with a continued focus on these countries as well.

OPIC's mandate should explicitly place developmental concerns as the foremost criterion in the selection of projects which it will insure. It should have minimal concern with standard risk insurance practices, and should not base its selection on the projects' impact on the United States. The program should recognize explicitly that it is pursuing a goal of public policy, and seek appropriation of public funds as necessary to finance it.[83] Since the volume of foreign direct investment to the poorest countries will not be sizable even with insurance, and since these countries can scarcely compete with the United States in its own or world markets, there should be little concern over the elimination of concern with "U.S. effects."[84]

Balance-of-Payments Controls

A final U.S. policy effort to stimulate the flow of foreign direct

83 OPIC is financially self-sufficient at present. To attain this position, it (a) charges insurance premia which are sufficiently high to deter some potential investors, (b) rejects some projects whose development potential is high, and (c) looks actively for projects in more developed (and hence less risky) countries. A renewed focus on development alone would require changes in all three policies, and hence some use of appropriated funds.

84 In American Multinationals and American Interests, we propose two major additional roles for OPIC: active promotion of foreign direct investment in raw materials throughout the world on a non-equity basis, to increase the output of such materials on a less unstable basis than now exists, and coordination of the whole range of new U.S. policies toward foreign direct investment proposed in the volume, through making the President of OPIC simultaneously Special Representative (to the President) for International Investment Policy. See Chapter Thirteen.

investment to less developed countries, or at least avoid deterring it, was the "preferential treatment" of LDCs under the balance-of-payments controls program which existed from 1965 through January 1974. The United States, faced with what turned out to be a problem of fundamental disequilibrium in its balance of payments, sought to reduce the deficit -- or at least appear to be doing something to reduce the deficit -- by controlling the outflow of private capital. The controls program resulted from the unwillingness of the United States to effect fundamental adjustment of its balance-of-payments disequilibrium, which in turn related to the inadequacies of the international monetary system rather than from any basic reversal of U.S. attitudes toward foreign direct investment. Indeed, the controls had little if any effect on the global level of foreign direct investment because the multinationals were able to borrow sufficient capital abroad to proceed with their desired plant and equipment expenditures.

The controls program, which became mandatory in 1968, contained two facets which sought to favor LDCs. First, the quota for capital permitted to flow to the LDCs was far more generous than for other countries. For most developed countries, capital flows were restricted to 35 percent of the historical yearly average. For developed countries with special problems of their own, the allowance was 65 percent. For the LDCs, however, the allowance was set at 110 percent of the historical average -- hence permitting continued growth. Second, the rules permitted unused portions of the quota set for the developed areas to be utilized routinely

in the less developed countries, though unused portions of LDC quotas could not be applied to industrialized countries without severe restrictions.

It is difficult to assess the impact of the capital controls on the flow of investment to the developing countries. The intent was to force foreign investors to utilize non-U.S. savings, rather than U.S. capital, to finance their investment projects. The bulk of the increase in foreign debt financing took place in the developed countries. However, the phenomenon may have spread to the LDCs during the life of the program. For the first three years of the program, which were the strictest in terms of administration, the annual average share of external debt financing for manufacturing investment in the developed areas rose by 10 percentage points from the two years immediately preceding the institution of mandatory controls. Hence the controls program may have reduced the benefits of foreign direct investment in the LDCs by increasing its use of local savings.

Other Policies

There are a number of other U.S. policies which affect the contribution of foreign direct investment to development. For example, the Hickenlooper and Gonzales Amendments commit the U.S. Government to stop bilateral aid and oppose multilateral aid, respectively, in cases of uncompensated expropriation. Both are demonstrably ineffective even in resolving the dispute in question, however. They worsen, rather than improve, the "investment climate" and hence undermine developmental objectives as well. Both should be abolished.

Similarly, U.S. efforts to limit the flow of goods and technology to Communist countries have included extraterritorial limitations on the export opportunities of the subsidiaries of U.S. firms, including subsidiaries in developing countries. This limits exports directly, and deters foreign investment which might risk running afoul of such controls. Fortunately, the zeal of the United States to implement such controls has declined sharply in recent years -- partly due to the rising unwillingness of host (including developing) countries to permit the subsidiaries to comply. Nevertheless, abolition of the policy would end a needless deterrent to the potential developmental contribution of foreign direct investment.

In addition, we conclude in American Multinationals and American Interests that the United States should adopt several new national policies toward foreign direct investment by U.S.-based firms, and that U.S. interests would be promoted by the negotiation of new international rules and institutional arrangements to govern foreign direct investment. Both the new national policies and international rules would be modelled on existing regimes covering international trade. They would seek to provide a policy environment within which market forces would determine international investment flows, as a general rule, but where exceptions would be permitted to protect (a) national interests both of home and host countries (e.g., the "export of jobs" and the creation of "infant industries") and (b) the joint interests of all governments -- developed and developing alike -- in making effective their control over multinational

enterprises in certain areas where the global scope of the firms may enable them to avoid all national jurisdictions (e.g., transfer pricing and antitrust).

Specific provisions to favor the poorest countries could be built into three of our proposals. One relates to the "escape clause for investment," modeled on the traditional trade escape clause, under which U.S. parties (such as groups of workers) which felt themselves injured by a particular foreign direct investment could petition for relief from that investment -- either through blockage of the investment, or through the provision of adjustment assistance to the workers. Investments in the poorest countries could be exempted from such action or, alternatively, adjustment assistance to injured parties could be required in lieu of action against the investments themselves.

Second, our proposed new international rules and institutional arrangements would seek to limit the use of tax and other incentives by host countries to entice investments, and the use of "performance requirements" through which host (including developing) countries are increasingly harnessing multinational enterprises to promote their national goals -- and, in the process, frequently transferring production (and hence jobs, exports and technology) out of home countries. Again, the poorest countries could be exempted from the general prohibition. However, the rules would be partly aimed at some of the more advanced developing countries, such as Brazil and Mexico, which should be covered from the outset; a clear distinction between Third World and Fourth World countries would be required to implement the conceptual distinction.

Third, our proposed new international rules would seek to deal with a number of the abuses via which multinational enterprises are frequently charged with distorting the development process -- manipulative transfer pricing, marketing restrictions on subsidiaries, and other restrictive business practices. The creation of effective international rules to check these practices would support development in three ways: by halting the practices per se, by ending the disproportionate attention which they now receive from officials in developing countries and thereby freeing those officials for more productive enterprises, and by eliminating a major source of the erosion of the "investment climate" which limits the potential flow of foreign direct investment to the poorer countries.

CONCLUSION

Though current U.S. policy avowedly seeks to support foreign direct investment in the LDCs, the various measures which aim to do so leave much to be desired. Some general features of the U.S. tax system discriminate against foreign direct investment, including investment in the developing countries, though some others favor it. Assuming inviolability for the foreign tax credit, which rests on very strong principles, the net impact of the present U.S. tax system is probably negative for foreign investment: its exclusion from coverage by the Investment Tax Credit, and the discrimination against it implied by DISC, probably outweigh the favorable effects on it of deferral and the other small incentives.[85]

85 The U.S. Treasury Department, op.cit., p. 25, estimates that the achievement of perfect capital-export neutrality would reduce U.S. tax revenues by $1.5-3 billion, implying a fairly significant bias against foreign direct investment in the current tax law.

The tax mechanisms specifically applicable only to LDCs are dated, poorly designed and at best only minimally effective. Even deferral and the overall option for calculating the foreign tax credit, whose validation of LDC tax incentives makes them the most important devices for promoting investment in the LDCs, are generalized to all investments and cannot discriminate among them on the basis of their development potential; leave the burden of the subsidy mainly on the LDC itself; and encourage country shifts and transfer pricing by the firms. They should be replaced by extension to the poorer countries of the Investment Tax Credit, as now applied to investment in the United States or in somewhat modified form; by a special investment credit for such countries, based on the Boggs bill of 1964; or, if deferral is eliminated, tax sparing agreements with individual countries. Whatever option is chosen should be implemented through tax treaties to permit maximum selectivity of coverage.

The OPIC program, designed to provide low-cost risk insurance, has steadily become more concerned with the impact on the home country than the developmental needs of the host country. It should therefore focus solely on the countries of the Fourth World, which continue to need home-country help in attracting foreign direct investment, and eliminate its concern

about the effects of projects on the U.S. economy. The trend toward "privatizing" many of its functions should also be reversed, to permit re-focusing on development objectives.

Trade policy could be more responsive to development objectives, in particular through foreign direct investment combined with exports to home markets. Key possibilities include liberalizing the existing system of tariff preferences in several ways, retaining Sections 806 and 807, and focusing on products of interest to LDCs in the Multilateral Trade Negotiations.

In summary, there is substantial room for improvement of U.S. policies to enhance the contribution of foreign direct investment to development in the Third and Fourth Worlds. Adoption of the proposals made here would represent an important change not only in specific policies but also in U.S. philosophy toward foreign direct investment in the developing countries. In particular, they would alter the tax system, in a substantial way for the first time, to support such investment. They would express a move away from generalized support towards a much greater degree of selectivity of countries, industries in which foreign direct investment is promoted, and perhaps even production techniques, with an eye to generating jobs and improving income distribution more directly. In view of the evidence presented in this paper -- that present U.S. policy could do much more to encourage foreign direct investment in the poorer countries, and that the contribution of such investment to development depends heavily on the specifics in particular cases and the interactions between policies of the host and home countries -- such a shift seems justifiable.

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